The First Great Law & Economics Movement

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I. Introduction

Beginning in the 1880s and throughout the Progressive Era, American economists turned their attention to the law in a way unprecedented in American thought. Some legal academics in turn incorporated economics into their thinking about the law. Whether their output or its impact were great enough to warrant calling their efforts a law & economics[1] "movement" is worth debating. This essay argues that there was such a movement, examines its nature and influence on American legal and economic thought, and compares that movement with the law & economics of today. I present the main works of the brightest stars of the first law & economics movement with a dual purpose. First, I hope to encourage students to read these works and recognize the great values—some no longer recognized—of their approach and lessons. Second, I hope to provide the reader with a historical perspective from which to recognize that the biases and postures of today's law & economics movement are not logically necessary nor ordained by the natural rules of the discipline.

Law has traditionally been divided into explicitly economic and noneconomic subjects. The law of antitrust, trade restraints, and regulated industries has entertained explicit economic analysis for the last century or more.[2] In other subjects such as labor law, corporate law, and the constitutional law of economic relations judges have indulged in a substantial amount of economic analysis, although not as explicitly as in regulatory subjects.[3] In common law subjects such as torts, contracts, and the law of property interests judges have not incorporated

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1. The phrase "law & economics" is used in this essay with an ampersand to suggest a single area of activity that is neither wholly law nor wholly economics. The phrase "law and economics" refers to a pair of discrete disciplines.

2. *See* Herbert Hovenkamp, *The Antitrust Movement and the Rise of Industrial Organization*, 68 Tex. L. Rev. 105 (1989); Herbert Hovenkamp, *Regulatory Conflict in the Gilded Age: Federalism and the Railroad Problem*, 97 Yale L.J. 1017 (1988); Herbert Hovenkamp, *The Sherman Act and the Classical Theory of Competition*, 74 Iowa L. Rev. 1019 (1989).

3. *See* Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 Geo. L.J. 1593 (1988); Herbert Hovenkamp, *Labor Conspiracies in American Law, 1880-1930*, 66 Tex. L. Rev. 919 (1988); Herbert Hovenkamp, *The Political Economy of Substantive Due Process*, 40 Stan. L. Rev. 379 (1988).

much explicit economic analysis until recently, although they often did so implicitly.[4]

The modern law & economics movement actually refers to the work of a group of economists and legal academics who carried economic analysis beyond explicitly regulatory subjects and into all areas of the law. The origin of the movement is sometimes identified with Ronald Coase's famous 1960 essay, *The Problem of Social Cost*,[5] but the movement really accelerated and attracted large numbers of people outside the University of Chicago in the early 1970s.

The 1970s law & economics movement is sometimes presented as a distinctly new approach to legal analysis, much broader in either its scope or its influence than anything that came before. Judge Richard Posner concluded in 1986 that

> [u]ntil 25 years ago economic analysis of law was almost synonymous with economic analysis of antitrust law . . . .
>
> However, the hallmark of the "new" law and economics—the law and economics that is new within the last 25 years—is the application of the theories and empirical methods of economics to the legal system across the board . . . .[6]

The first great law & economics movement did very much the same thing as the current movement. It began in a regulatory subject—the creation and administration of an interstate railroad system,[7] quickly moved into the law of trade restraints,[8] and then into more general legislative and common law subjects such as criminal law, corporation law, tax, property and contract. The scope of the first great law & economics movement was broad, and its influence on American lawmakers has been surprisingly underestimated.

The ideology of the first great law & economics movement, however, differed greatly from that of the second. The first great law & economics movement grew out of a reaction against emergent neoclassicism and a search for alternatives. The law & economics movement of the 1970s and 1980s, on the other hand, is influenced heavily by a revitalized neoclassicism with a strong promarket, generally antistatist bias.[9] Equally important, when the first great law & economics move-

4. For common law judges' use of economics, see PAUL H. RUBIN, BUSINESS FIRMS AND THE COMMON LAW: THE EVOLUTION OF EFFICIENT RULES (1983); Herbert Hovenkamp, *The Economics of Legal History*, 67 MINN. L. REV. 645 (1983).

5. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

6. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 19 (3d ed. 1986).

7. *See* Hovenkamp, *Regulatory Conflict in the Gilded Age: Federalism and the Railroad Problem*, *supra* note 2.

8. *E.g.*, JOHN BATES CLARK & JOHN MAURICE CLARK, THE CONTROL OF TRUSTS (1914); RICHARD T. ELY, MONOPOLIES AND TRUSTS (1900). Other literature is discussed in HANS B. THORELLI, THE FEDERAL ANTITRUST POLICY: ORIGINATION OF AN AMERICAN TRADITION (1955), and Hovenkamp, *The Antitrust Movement and the Rise of Industrial Organization*, *supra* note 2.

9. Although this certainly does not account for everyone—*e.g.*, JULES L. COLEMAN, MARKETS, MORALS AND THE LAW (1988); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985); OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES (1975); Robert D.

ment was in its heyday, positivistic methodology as we know it today had not yet arrived.[10]

In contrast with today's law & economics movement, the first great law & economics movement was dominated by the more liberal American economists. Most of these economists were interested in the relationship between the law and the distribution of wealth in American society. Those who participated in the first great law & economics movement were generally dubious about markets and about the common law as a welfare-enhancing device. As a result, any comparative study of the impact of the two movements must consider the influence of the first on Progressive era *legislation* rather than on common law rules.

II. Part One: The Economic Challenges to Classicism from Progressive Era Law & Economics

A. *The Era of Turbulence in Economics*

At the turn of the century, economics was going through a difficult and intellectually violent revolution, with great disagreement in the academic community over the proper methods of analysis. Marginal utility theory, which began to develop within the classical political economy in the 1870s, had turned classicism's doctrine of value upside down and substantially undermined its theory of cost. However, the modern competition model that we today identify with the marginalist revolution had not yet matured.[11] The importance of marginal utility theory would not be fully realized until the 1920s, but by 1900 many economists were uneasy about utilitarianism's impact on classicism's defense of the market and restrictions on state interference in enterprise and private affairs.

Equally threatening to classical political economy was the German Historical School—a phenomenon that captured many students in economics in the 1870s and 1880s.[12] German Historicism was in many

Cooter, *Liberty, Efficiency, and Law*, 50 LAW & CONTEMP. PROBS. 141 (1987); Louis Kaplow, *Antitrust, Law & Economics, and the Courts*, 50 LAW & CONTEMP. PROBS. 181 (1987); Richard S. Markovits, *A Basic Structure for Microeconomic Policy Analysis in Our Worse-than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics*, 1975 WIS. L. REV. 950, 987; A. Mitchell Polinsky, *Economic Analysis as a Potentially Defective Product: A Buyer's Guide to Posner's Economic Analysis of Law*, 87 HARV. L. REV. 1655 (1974).

10. The word "positive" was known to economists, but it referred only to descriptive, or empirical research, or to inductive, rather than deductive reasoning. *E.g.*, E. Böhm-Bawerk, *The Positive Theory of Capital and Its Critics* (pts. 1-3), 9 Q.J. ECON. 113, 235 (1895), 10 Q.J. ECON. 121 (1896); Frederick B. Hawley, *A Positive Theory of Economics*, 16 Q.J. ECON. 233 (1902); *see also* FRANCIS BOWEN, THE PRINCIPLES OF POLITICAL ECONOMY APPLIED TO THE CONDITION, THE RESOURCES, AND THE INSTITUTIONS OF THE AMERICAN PEOPLE 33 (Boston 1856); Lester F. Ward, *Scientific Basis of Political Economy* (pts. 1 & 2), 12 INT'L REV. 352 (1885), 12 INT'L REV. 439 (1885).

11. *See* George J. Stigler, *Perfect Competition, Historically Contemplated*, 65 J. POL. ECON. 1 (1957).

12. *See* Hovenkamp, *The Antitrust Movement and the Rise of Industrial Organization*, *supra* note 2.

ways inconsistent with neoclassicism, but for a time, it appeared to be the wax that could bind the social sciences. The debate over historicism highlighted the uncertainty within the economic community as to whether economics was a behavioral, historical, or a purely formal science. Classicism and neoclassicism leaned strongly towards formalism; historicism was much more social and eclectic.[13]

Finally, two developments, one technical and one institutional, laid the foundation for the first law & economics movement. The first was higher mathematics. Marginal utility theory used mathematics in a way generally unknown to the classicists. F.Y. Edgeworth and Alfred Marshall in England, and Irving Fisher and John Bates Clark in the United States, expressed economics in a new and far more technical language.

The second development, related to the first, was a more professional and specialized cadre of practicing economists. In 1885, the American Economics Association was formed. The subsequent emergence of the economists' professional journals in the United States in the 1890s[14] meant that the days were over when professional economists debated in the *North American Review* or *Princeton Review* with clergymen and business persons. Such journals might be suitable for popularization, but serious work meant specialized forums.[15]

It is difficult to overestimate the impact of these changes on the economists' identity or on the nature of their work. The new theories called into question the basic assumptions of economics. The Progressive Era economists, particularly those writing about law & economics, argued strenuously over the basic ground rules of economics. Almost nothing was a given. Famous essays in law & economics, such as Henry Carter Adams's *The Relation of the State to Industrial Action* (1887),[16] began by debating such basic assumptions as whether human beings act rationally to maximize their individual interests, and whether these interests reliably coincide with the interests of society.[17]

By contrast, the 1970s law & economics movement emerged at a time when the economists' basic model, neoclassicism, was well developed and quite uncontroversial, at least among the group of economists that dominated the new discipline. Whatever its revolutionary impact on law, the *economics* of the 1970s law & economics movement is strictly "normal" science—science within the consensus model.[18] This means two things. First, the 1970s movement has been capable of great technical "progress" because of the degree of consensus about

13. The debate is recounted in some detail in *id.* at 109-18.

14. Hovenkamp, *The Political Economy of Substantive Due Process*, *supra* note 3, at 398-99.

15. On the professionalization of the social sciences, see MARY O. FURNER, ADVOCACY & OBJECTIVITY: A CRISIS IN THE PROFESSIONALIZATION OF AMERICAN SOCIAL SCIENCE, 1865-1905 (1975).

16. 1 PUBLICATION AM. ECON. A. 471 (1887).

17. *Id.* at 479-81.

18. *See* THOMAS S. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS 23-42 (2d ed. 1970).

the model. When no one debates fundamental assumptions and everyone applies a consensus model to legal rules, the appearance of progress is substantial.

Second, while there has been substantial progress, the progress has occurred within a narrow set of boundaries—so narrow that fundamental questions, such as whether "welfare" properly means the same thing for the legal policymaker and for the economist, have been read out of the debate. To look at it another way, the 1970s law & economics movement has made a great deal of rapid progress by assuming away certain fundamental issues for which there is substantial consensus within the modern neoclassical economics community. But these issues may need re-examination when the discipline is not "economics" but rather "law & economics."

B. *The Early Practice of Law & Economics*

1. *Origins: The Adamses, Progressivism and the Historical School.*

Charles Francis Adams and Henry Carter Adams. The first great law & economics movement preceded the Progressive Era and lay close to the origins of modern American regulatory policy. Charles Francis Adams, "prophet" of modern American regulatory theory,[19] identified market failure in the railroads as the principal justification for legal regulation. As Adams argued in 1876,[20] railroads needed to be regulated by the state while other industries did not because the railroads could not be made subject to the same laws of "competition and free trade" as other industries; in fact, railroad operation would be reduced to "utter confusion within and without" under free market control.[21] Adams then indulged in a long attack on British neoclassical economics for trying to generalize for all industries after hypothesizing a small number of invariable laws. The railroads illustrated that neoclassical price theory did not apply equally to every situation. He believed the German Historical approach to economics was more effective than British neoclassicism for studying economic phenomena in particular industries.[22]

A decade later Henry Carter Adams expressed the same theme in a more general fashion in *Economics and Jurisprudence*.[23] Adams argued that the German Historical method was far better suited to addressing legal questions than was British neoclassicism, for the latter failed to see legal phenomena in their historical and cultural complexity. This argument drew the early lines for the emerging battle between neoclas-

19. *See* THOMAS K. MCCRAW, PROPHETS OF REGULATION 1-79 (1984).

20. Charles Francis Adams, Jr., *The State and the Railroads* (pts. 1 & 2), 37 ATLANTIC MONTHLY 360, 691 (1876).

21. *Id.* at 692.

22. On the German Historical School and the study of particular industries, see chapters 22 and 23 in HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW: 1836-1937 (1990) (forthcoming).

23. Henry Carter Adams, *Economics and Jurisprudence*, 8 SCIENCE 15 (July 2, 1886).

sicists and Progressive economists over the relative value of historical and analytical approaches to economic theory. The first great law & economics movement was born out of this debate.

In his most important theoretical essay, *The Relation of the State to Industrial Action*, Henry Carter Adams dealt with the pervasive problem of the appropriate relationship between state industrial policy and economic theory. He argued that the "collapse of faith in the sufficiency of the philosophy of laissez-faire, has left the present generation without principles adequate for the guidance of public affairs."[24] Adams conceded the great power of laissez-faire as an economic model, but noted that its premise that unregulated self-interest would yield optimal economic development had never been proven.[25] In some areas of enterprise, such as railroads and other industries subject to substantial economies of scale, laissez-faire seemed not to work.

Adams distinguished between "free competition" as a principle which he accepted, and "laissez-faire" as a dogma which he rejected. The principle of free competition was a value long appreciated in British political economy, but the dogma of laissez-faire was nothing more than an attempt by political conservatives to turn scientific economic inquiry into a kind of religious belief. The legal conditions favoring competition were private property in land, labor, capital, and liberty of contract "for all alike."[26] In addition, competition would work only when there was "ease of movement" for both labor and business, because this forces people's attention toward the future rather than the present.[27]

The dogma of laissez-faire, on the other hand, was an uncritical acceptance of the notion that free competition could be maintained without the sovereign's assistance. Laissez-faire required an all or nothing attitude toward monopoly and industry coordination. Its protagonists failed to recognize that although some monopolies are bad, others are good and must be tolerated or even encouraged. But only an economically active state could separate the sheep from the goats.[28] In short, a state's legal policy towards business needed to make distinctions that neoclassicism, with its small number of broadly sweeping rules, refused to make. Once again, Adams preferred the relatively ad hoc, industry-specific approach of the German Historical method.

The appropriate role of the active state occupies most of the remainder of Adams's essay. Efficient industrial development demands an active state, Adams argued, because the optimal amount of competition is by no means constant from one industry to the next; and private firms cannot be trusted to settle on the optimal amount themselves. In

24. Adams, *supra* note 16, at 477-78.
25. *Id.* at 479.
26. *Id.* at 499.
27. *Id.* at 500.
28. *Id.* at 502, *passim.*

labor, unrestrained competition appeared to drive wages to subsistence levels, and even unionization seemed not to alleviate the problem.[29] Other markets tended naturally toward monopoly. Furthermore, the active government could realize the benefits of monopoly for society.[30] The economically sophisticated state would recognize that in some industries, monopoly is clearly more efficient than competition. By state regulation, the benefits of monopoly could be conferred upon society rather than the monopoly business firms themselves.[31]

Adams called upon public officials and lawmakers to become sophisticated in economics so that they could determine when industries could be left to competition and when some form of regulatory intervention was appropriate. As a rule for guidance, he divided industries into three classes: industries of constant returns, industries of diminishing returns, and industries of increasing returns.[32] This simple observation—based on the notion that the long-run average cost curve need not be perfectly horizontal—had the potential to move regulatory theory forward substantially. Industries that displayed constant or decreasing returns to scale needed little or no state intervention, argued Adams, for competition could be trusted to make them work optimally.[33] The large firm was not at an advantage over the small firm. Entry and mobility were therefore easy, and there was little reason for thinking that one giant could eliminate the competition of smaller rivals.

Industries exhibiting increasing returns to scale were a different matter. Here the large, well-established firm was always at an advantage over the new entrant.[34] "[W]here the law of increasing returns

29. *Id.* at 507-08.

30. *Id.* at 511-28.

31. *Id.* at 517.

32. *Id.* at 519.

33. *Id.* at 520-22. Richard Ely agreed and developed this conclusion. Ely believed that competition generally forced the owner of productive property to put it to a socially valuable use. But there were certain industries in which costs declined continuously as output increased. In these "natural monopolies," competition would not work, because the larger firm would always have a cost advantage over smaller rivals. *See* RICHARD T. ELY, AN INTRODUCTION TO POLITICAL ECONOMY (1889); R. ELY, *supra* note 8, at 39-95; RICHARD T. ELY, SOCIALISM: AN EXAMINATION OF ITS NATURE, ITS STRENGTH AND WEAKNESS, WITH SUGGESTIONS FOR SOCIAL REFORM 262-63 (1889); Richard T. Ely, *Municipal Ownership of Natural Monopolies*, 172 N. AM. REV. 445 (1901); Richard T. Ely, *Natural Monopolies and the Workingman*, 158 N. AM. REV. 294 (1894); *see also* SIDNEY FINE, LAISSEZ FAIRE AND THE GENERAL WELFARE STATE: A STUDY OF CONFLICT IN AMERICAN THOUGHT, 1865-1901, at 211, 217, 227 (1976); BENJAMIN G. RADER, THE ACADEMIC MIND AND REFORM: THE INFLUENCE OF RICHARD T. ELY IN AMERICAN LIFE 88-105 (1966); John R. Commons, *Protection and Natural Monopolies*, 6 Q.J. ECON. 479 (1894). The natural trend in such industries was toward a single firm controlling the entire market. Competition would not discipline the firm's pricing. The resulting "unearned income" belonged to society rather than the firm. R. ELY, SOCIALISM: AN EXAMINATION OF ITS NATURE, ITS STRENGTH AND WEAKNESS, WITH SUGGESTIONS FOR SOCIAL REFORM, *supra*, at 262, 294-96.

34. "[I]t is easier for an established business to extend its facilities for satisfactorily meeting a new demand than for a new industry to spring into competitive existence." Adams, *supra* note 16, at 524.

works with any degree of intensity, the principle of free competition is powerless to exercise a healthy regulating influence."[35] Adams stated that the "control of the state over industries should be coextensive with the application of the law of increasing returns in industries."[36] He cited the railroads as the most obvious example of an industry that displayed increasing returns, although there were others as well. Such industries were "by nature, monopolies" and should be regulated accordingly.[37]

Adams concluded with an attack on state and local government, arguing that the toleration of unregulated monopolies, particularly municipal franchises for gas, water, and public transportation, had led to widespread municipal corruption. The result was that the public lost both the benefit of efficient industry and the government they deserved.[38]

The Relation of the State to Industrial Action is an extraordinary piece of law & economics, particularly when one considers that it was written before marginalism had much impact on American economics, and before American economists as a group turned their attention to monopolies and trusts and attendant regulatory problems.[39] Its perspective on regulation is surprisingly modern, especially its development of an economic basis (scale economies) for distinguishing regulated from competitive industries, and its argument that local government was a common source of monopoly and regulatory mismatch. Here were the seeds of the modern theory of economic regulation as well as of regulatory "capture."[40]

2. *The material welfare school.*

Modern welfare economics grew out of the "marginal utility" school of the late nineteenth century. This school's members, who were also the first neoclassicists,[41] gave us marginalism—the important concepts

35. *Id.*

36. *Id.*

37. *Id.* at 528. Apparently Adams did not distinguish between industries that were subject to scale economies up to some finite output level, which may be much less than market demand when price equals marginal cost, and those in which economies of scale were "global." The former might be absolutely competitive, even though individual firms might be rather large and new entry difficult, depending on the extent of scale economies. In the latter, a competitive equilibrium might not be possible.

On Adams and the failure of competition in the railroad industry, see Hovenkamp, *Regulatory Conflict in the Gilded Age: Federalism and the Railroad Problem*, *supra* note 2, at 1017, 1020, *passim*.

38. Adams, *supra* note 16, at 532-39.

39. *See* Hovenkamp, *The Antitrust Movement and the Rise of Industrial Organization*, *supra* note 2; Hovenkamp, *The Sherman Act and the Classical Theory of Competition*, *supra* note 2, at 1025-41.

40. *See The Rise of Regulated Industry*, in H. HOVENKAMP, *supra* note 22, chs. 12-13.

41. The most important members of the marginal utility school in the British tradition were William S. Jevons and Alfred Marshall. Equally important on the Continent were Karl Menger and Léon Walras. The important Americans were John Bates Clark, Simon Patten, Frank Fetter, and Irving Fisher. *See* FRANK HYNEMAN KNIGHT, *Marginal Utility Economics*, in THE ETHICS OF COMPETITION 148-49 (1935).

of marginal cost and marginal revenue or satisfaction—as well as the notion that marginalism plus utilitarianism could be used to measure total welfare. The resulting "material welfare" school dominated economics in England and America from the turn of the century until around 1930. Two of the foremost economists of the material welfare school were Alfred Marshall and Arthur Cecil Pigou of Cambridge, but some of the American Progressives were prominent as well. These included Richard T. Ely, John R. Commons, Edwin R.A. Seligman, and Simon Patten.

The material welfare school believed that some involuntary transfers of wealth could make society as a whole better off. They derived this notion from two things: the law of diminishing returns and the concept of marginal utility. The law of diminishing returns suggested that a person obtained less pleasure from his tenth dollar than his first and much less pleasure from his millionth dollar than his tenth one. The concept of marginal utility suggested that society's utility would be maximized when individual marginal utilities were equalized. Thus, a forced transfer from the millionaire to the pauper would improve total welfare: One dollar was of little consequence to the wealthy but supremely important to the impoverished.[42] Carried to its logical conclusion, the transfer of dollars from the millionaire to the pauper would continue to improve total welfare until the millionaire and the pauper had the same amount of marginal utility for the next dollar.[43] At that point, a dollar taken from the millionaire would rob him of as much utility as it increased the utility of the pauper, and society would be neither better nor worse off.[44]

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42. *See, e.g.*, JOHN R. COMMONS, THE DISTRIBUTION OF WEALTH 10 (1893) ("To the poor man all the marginal increments may afford high satisfaction, because his supplies are limited; but to the rich man the marginal increments may give little satisfaction. Yet each, though on different levels, endeavours to make the marginal increments in all lines equal."); ALFRED MARSHALL, PRINCIPLES OF ECONOMICS 108 (8th ed. 1949) (1890) ("[A] pound's worth of satisfaction to an ordinary poor man is a much greater thing than a pound's worth of satisfaction to an ordinary rich man."); 1 F.W. TAUSSIG, PRINCIPLES OF ECONOMICS 132 (3d ed. 1921) ("The principle of diminishing utility, if applied unflinchingly, leads to the conclusion that inequality of incomes brings a less sum of human well-being than equality of incomes, and that the greater the inequality, the less the approach to maximum."); *see also* G.P. WATKINS, WELFARE AS AN ECONOMIC QUANTITY 185-90 (1915) (arguing that total social utility would increase if incomes were leveled somewhat and the right to inherit severely curtailed); J.B. Clark, *The Ultimate Standard of Value*, 1 YALE REV. 258 (1892) (arguing that social welfare is a function of aggregated individual utilities); Simon N. Patten, *The Scope of Political Economy*, 2 YALE REV. 264 (1893) (arguing that homogeneity of wealth and property tends to increase total utility); Jacob Viner, *The Utility Concept in Value Theory and Its Critics* (pts. 1 & 2), 33 J. POL. ECON. 369, 638 (1925) ("Changes in the relative distribution of income as between different classes will bring about changes in the amount of welfare, even though the aggregate real income of the community remains the same." *Id.* at 644 (footnote omitted)).

43. This would not necessarily mean that the two would have exactly the same amount of wealth; that would be the case only if they also had identical utility functions. If not, one person might derive equal subjective utility from fewer dollars than the other. *See* AMARTYA SEN, ON ECONOMIC INEQUALITY 16 (1973).

44. *See, e.g.*, A.C. PIGOU, ECONOMICS OF WELFARE 89 (4th ed. 1960) (1920):

[I]t is evident that any transference of income from a relatively rich man to a rela-

This concept of welfare helps to explain the high degree of statism among the economists of the material welfare school, who comprised the first great law & economics movement. They were Progressives, who believed that social welfare could be increased by minimum wage laws,[45] graduated income taxes,[46] subsidized public education, welfare payments to the poor, taxes on monopoly profits, and other devices by which the relatively wealthy were required to finance the provision of goods and services to the relatively impoverished. Health or safety regulation could also be justified as taxes on wealthy producers for the benefit of poorer consumers.[47] The beneficiaries of these forced transfers were perceived to gain more utility than the involuntary grantors lost. These views prevailed until a group of economists called the "ordinalists" argued vehemently and persuasively that utilities could not be quantified in a way that permitted comparison of one person's utility with that of another.

3. *Progressivity, welfare economics, and tax policy.*

By the turn of the century, marginal utility theory was already well developed in neoclassical economics.[48] Some effort had been made to use interpersonal comparisons of utility to justify progressivity in income taxation. The general argument was that since people derived less utility from each dollar as their income rose, taxing of higher incomes at higher levels would destroy less welfare per dollar of tax revenue received. Two neoclassical economists carried this position to the extreme—Thomas Nixon Carver in the United States and F.Y. Edgeworth in England. Although Carver published his work first, Edgeworth was the more prominent economist and has generally been credited with the development of the marginalist "minimum sacrifice" justification for progressive taxation.

An optimal tax policy, argued Carver, should raise needed revenue

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tively poor man of similar temperament, since it enables more intense wants to be satisfied at the expense of less intense wants, must increase the aggregate sum of satisfaction. The old "law of diminishing utility" thus leads securely to the proposition: Any cause which increases the absolute share of real income in the hands of the poor, provided that it does not lead to a contraction in the size of the national dividend from any point of view, will, in general, increase economic welfare. (footnote omitted).

45. *See* Samuel McCune Lindsay, *The Minimum Wage as a Legislative Proposal in the United States*, 48 ANNALS 45 (1913); Henry R. Seager, *The Minimum Wage as Part of a Program for Social Reform*, 48 ANNALS 3 (1913); text accompanying notes 85-108 *infra*. Citations to ANNALS here and *infra* refer to the *Annals of the American Academy of Political and Social Science*.

46. *See* text accompanying notes 48-67 *infra*.

47. *E.g.*, Carol Aronovici, *Housing and the Housing Problem*, 51 ANNALS 1 (1914); Miles M. Dawson, *The System Best Adapted to the United States*, 38 ANNALS 175 (1911); Alvah H. Doty, *The Federal Government and the Public Health*, 166 N. AM. REV. 543 (1898); John J. Murphy, *Some Effects of Housing Regulation*, 51 ANNALS 99 (1914); Charles Nagel, *Prevention of Industrial Accidents*, 38 ANNALS 71 (1911).

48. *See* George J. Stigler, *The Development of Utility Theory*, 58 J. POL. ECON. 307, 373 (1950); *see also* E.R.A. SELIGMAN, PRINCIPLES OF ECONOMICS ch. 12 (1905).

through minimal repression of citizens.[49] Because the marginal utility of money declines the more one has, the wealthy should be taxed more heavily. In fact, under the minimally repressive tax policy,

> The wealthiest man in the community would be taxed sufficiently to reduce his income and raise its final utility to a level with that of the next wealthiest man. Then these two would have to be taxed so as to raise the final utility of both their incomes to a level with that of the third, and so on till enough incomes were brought under the tax to raise enough revenue.[50]

All other persons would be exempt from the tax.[51]

In 1897, Edgeworth expressed the same argument in slightly different terminology, suggesting that the state should try to minimize aggregate disutility for a given amount of revenue raised.[52] Like Carver, Edgeworth believed that this would occur when each person was taxed to the point that one dollar in additional tax would produce equal amounts of disutility. If every person's utility curve were identical, this implied that each person should be taxed until the remaining income of everyone was exactly the same. But Edgeworth blanched at the socialistic implications of this position and immediately qualified it, suggesting that such leveling might reduce the incentive to produce and (worse still) increase the birth rate among the lower economic classes.[53]

Both Carver's and Edgeworth's theories assumed not merely that one could make interpersonal comparisons of utilities, but that different individuals' utility curves were actually identical, at least respecting money. Such economic defenses of progressivity in taxation were common in the United States until at least 1927, when Irving Fisher attempted to devise a statistical method for comparing utilities across families.[54] In the wake of the ordinalist critique of interpersonal com-

49. T.N. Carver, *Ethical Basis of Distribution and Its Application to Taxation*, 6 ANNALS 79 (1895) [hereinafter Carver, *Ethical Basis*]; *see* STEPHEN F. WESTON, PRINCIPLES OF JUSTICE IN TAXATION 205 (Columbia Studies in History, Economics and Public Law No. 2, 1903); Thomas N. Carver, *The Minimum Sacrifice Theory of Taxation*, 19 POL. SCI. Q. 72 (1904) (developing the theory of equimarginal sacrifice); Francis A. Walker, *The Bases of Taxation*, 3 POL. SCI. Q. 1, 14 (1888); *see also* W.P.J. BOK, DE BELASTINGEN IN HET NEDERLANDSCHE PARLEMENT, VAN 1848-1888 (1888). Bok, a Dutch economist, made an elaborate argument that the aggregate social "burden" of taxes could be minimized for a given amount of revenue needed by charging progressively higher rates on higher incomes. *Id.* at 177.

50. Carver, *Ethical Basis*, *supra* note 49, at 97.

51. E.g., if members *A*, *B*, *C*, & *D* of a society had individual incomes of $1000, $700, $500, and $300, respectively, and the sovereign desired to raise $1000, it should tax *A* by $600, *B* by $300, and *C* by $100, so that each would have $400 left. *D* would not be taxed and would thus have his entire $300 left. If the sovereign taxed *A* by less and *C* by more, total utility would be less because *C* would derive more utility from the additional dollars than *A* would.

52. F.Y. Edgeworth, *The Pure Theory of Taxation*, 7 ECON. J. 550 (1897).

53. *Id.* at 553-54.

54. IRVING FISHER, *A Statistical Method for Measuring "Marginal Utility" and Testing the Justice of a Progressive Income Tax*, in ECONOMIC ESSAYS CONTRIBUTED IN HONOR OF JOHN BATES CLARK 157, 157-93 (J. Hollander ed. 1927).

parisons of utility, such arguments were deemed unscientific.[55] Without such comparisons, progressive taxation could not be justified scientifically.[56]

The Progressive Era economist with the greatest explicit influence on judicial policymaking was Edward Robert Anderson Seligman.[57] Seligman, the most prominent public finance economist of his day, became a champion of the progressive income tax, which he defended on welfare principles.

Seligman's work on progressivity was part of an enormous body of Progressive American literature on the subject.[58] Most of Seligman's work was devoted to two issues of tax theory that lay at the heart of Progressive legislative policy: the justification for progressive rather than constant or proportional income taxes, and the shifting and incidence of taxation.

Marginal utility and progressivity. In 1894, Seligman acknowledged the power of arguments for progressivity based on the marginal utility theory.[59] Ultimately, however, he found the arguments unpersuasive, as had John Stuart Mill almost a half century earlier. Each based his skepticism on a doubt that the law of diminishing returns applied in exactly the same way to different people.[60] Seligman concluded that, "[m]athematics cannot help us here because the very first conditions

55. *See* [LIONEL,] LORD ROBBINS, AN ESSAY ON THE NATURE AND SIGNIFICANCE OF ECONOMIC SCIENCE 141 (2d ed. 1935); *see also* text accompanying notes 211-226 *infra*.

56. For the ordinalist critique, see Elmer D. Fagan, *Recent and Contemporary Theories of Progressive Taxation*, 46 J. POL. ECON. 457 (1938).

57. On Seligman's career, see 4 JOSEPH DORFMAN, THE ECONOMIC MIND IN AMERICAN CIVILIZATION: 1918-1933, at 257-66 (1959).

58. *See, e.g.*, Harry Gunnison Brown, *The Ethics of Land Value Taxation*, 25 J. POL. ECON. 464 (1917); Alzada Comstock, *Proposals for the Taxation of Wealth in Great Britain*, 28 J. POL. ECON. 399 (1920); Fred Rogers Fairchild, *Suggestions for Revision of the Federal Taxation of Income and Profits*, 10 AM. ECON. REV. 785 (1920); Fisher, *supra* note 54; Emory R. Johnson, *Relation of Taxation to Monopolies*, 4 ANNALS 764 (1894) (arguing that welfare could be increased by taxing monopolies more); A.C. Miller, *Dissertation Reviews*, 2 J. POL. ECON. 314 (1893) (review of Max West, *The Inheritance Tax* (1893)); Wesley C. Mitchell, *The Inheritance Tax Decision*, 8 J. POL. ECON. 387 (1899); E.A. Ross, *Taxation and Public Ownership, A New Cannon of Taxation*, 8 PUBLICATION AM. ECON. A. 49 (1893); Edwin R.A. Seligman, *The Progress of Taxation During the Past Twenty-Five Years, and Present Tendencies*, 11 PUBLICATION AM. ECON. A. 331 (1909); Edwin R.A. Seligman, *Progressive Taxation in Theory and Practice*, 9 PUBLICATION AM. ECON. A. 1 (1894); Edwin R.A. Seligman, *The Theory of Progressive Taxation*, 8 PUBLICATION AM. ECON. A. 52 (1893); George Tunell, *The Legislative History of the Second Income-Tax Law*, 3 J. POL. ECON. 311 (1895); *see also* Charles G. Haglund, *Fundamental Economic and Legal Difficulties with Taxation and Some Suggested Remedies*, 21 KY. L.J. 260 (1933) (the government should tax income, not property, since income is a better measure of wealth).

59. Seligman, *Progressive Taxation in Theory and Practice*, *supra* note 58, at 137-40.

60. *Id.* at 144. As Mill stated in PRINCIPLES OF POLITICAL ECONOMY, the conclusion that

> to take £100 from £1000 . . . is a heavier impost than £1000 taken from £10,000 . . . seems to me too disputable altogether, and even if true at all, not true to a sufficient extent, to be made the foundation of any rule of taxation. Whether the person with £10,000 a year cares less for £1000 than the person with only £1000 a year cares for £100, and if so, how much less, does not appear to me capable of being decided with the degree of certainty on which a legislator or a financier ought to act.

2 JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY 400 (5th London ed. 1896). Mill's doubts probably came less from the fact that he thought interpersonal comparisons of utility

fail us, the power to gauge with accuracy the mathematical relations of [interpersonal] marginal utilities."[61]

Seligman opted for a theory of progressivity based on objective rather than subjective welfare criteria.[62] He called his theory the "faculty" theory and derived it from the notion that human provisions can be divided into three rough categories: necessities, comforts, and luxuries. Even though different people place different values on specific things, most people place greater value on necessities, somewhat less value on comforts, and still less value on luxuries.[63]

Seligman recognized that the state, unlike the theoretical economist, works with approximations and objective categories. In response to the argument that the state could never justify progressivity, given the impossibility of comparing marginal utilities from one person to another, he concluded:

> If we take a general view and treat of the average man,—and the government can deal only with classes, that is, with average men,—it seems probable that on the whole less injustice will be done by adopting some form of progression than by following the universal rule of proportion. A strictly proportional rate . . . will be a heavier burden on the typical average poor man than on the typical average rich man.[64]

The Supreme Court's 1895 decision striking down the income tax[65] prompted a good deal of economic criticism, particularly of the Court's conclusion that the income tax was a "direct" tax, which under the Constitution had to be apportioned among the several states.[66] By the 1890s, a broad consensus had emerged that taxes on expenditures, or excise taxes, were generally regressive, unless confined to luxuries, while income taxes were progressive. To the economists of its day, the Gilded Age Supreme Court was interpreting the Constitution to permit regressive taxation but prohibit progressive taxation.[67]

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impossible than the fact that he had not given much thought to the economics of marginalism and its application to the concept of diminishing returns.

61. EDWIN R.A. SELIGMAN, THE INCOME TAX 31 (2d ed. 1914); *see also* Seligman, *Progressive Taxation in Theory and Practice, supra* note 58, at 144-45.

62. On the difference, see text accompanying notes 206-210 *infra.*

63. Seligman, *Progressive Taxation in Theory and Practice, supra* note 58, at 132-33. The theory also justified taxation of the sale of luxuries at higher rates than taxation of comforts, and of comforts at higher rates than necessities.

64. E. SELIGMAN, *supra* note 61, at 32-33.

65. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

66. U.S. CONST. art. I, § 2 ("[D]irect taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers.").

67. *E.g.,* A.C. Miller, *National Finance and the Income Tax,* 3 J. POL. ECON. 255, 275-77 (1895); Edwin R.A. Seligman, *Is the Income Tax Constitutional and Just?,* 19 FORUM 48 (1895); Tunell, *supra* note 58, at 318-25 (noting that the Democrats favored taxes on income); *see also* Charles J. Bullock, *Direct Taxes and the Federal Constitution* (pts. I & II), 9 YALE REV. 439 (1901), 10 YALE REV. 6 (1901) (historical meaning of "direct tax" in the Constitution, looking at contemporary economic literature at the time of the Constitutional Convention); Max West, *The Income Tax and the National Revenues,* 8 J. POL. ECON. 433 (1900). For a different view of the tax decision, by a conservative lawyer, see Christopher G. Tiedeman, *The Income Tax Decisions as an Object Lesson in Constitutional Construction,* 6 ANNALS 268, 276-79 (1895).

The shifting and incidence of taxation. Seligman's first major contribution[68] to the economic theory of taxation was a monograph on the shifting and incidence of taxation.[69] Seligman was not the first economist to consider where the burden of taxes actually falls. Prior to Seligman, Adam Smith, David Ricardo, and Augustin Cournot had analyzed the problem at some length.[70] Others, such as Jean-Baptiste Say and Alfred Marshall, had discussed it in cursory fashion.[71] In the United States, Seligman's work prefaced an outpouring of scholarship on the economics of tax policy. The voluminous law & economics literature on the shifting and incidence of taxation stretched all the way to the New Deal era.[72]

68. Seligman had written more limited essays earlier. *See* Edwin R.A. Seligman, *The General Property Tax*, 5 POL. SCI. Q. 24 (1890) (attacking the regressivity of property tax); Edwin R.A. Seligman, *The Taxation of Corporations* (pts. 1 & 2), 5 POL. SCI. Q. 269, 438 (1890) (describing the historical and current systems of corporate taxation).

69. Edwin R.A. Seligman, *On the Shifting and Incidence of Taxation*, 7 PUBLICATION AM. ECON. A. 119 (1892).

70. AUGUSTIN COURNOT, RESEARCHES INTO THE MATHEMATICAL PRINCIPLES OF THE THEORY OF WEALTH 67-89 (1927) (N. Bacon trans. 1897) (1838); DAVID RICARDO, THE PRINCIPLES OF POLITICAL ECONOMY AND TAXATION 81-150 (1963) (3d ed. 1821); ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 777-858 (E. Cannan ed. 1937) (5th ed. 1789) (1776).

71. A. MARSHALL, *supra* note 42, at 442, 686-87; J. MILL, *supra* note 60, at 394-467; JEAN-BAPTISTE SAY, A TREATISE ON POLITICAL ECONOMY OR THE PRODUCTION, DISTRIBUTION AND CONSUMPTION OF WEALTH 465-69 (1880 & reprint 1971); *see also* THOMAS EDWARD CLIFFE-LESLIE, *The Incidence of Imperial and Local Taxation on the Working Classes*, in ESSAYS IN POLITICAL AND MORAL PHILOSOPHY 192 (1879); JOHN R. MCCULLOCH, A TREATISE ON THE PRINCIPLES AND PRACTICAL INFLUENCE OF TAXATION AND THE FUNDING SYSTEM 40-409 (1968) (2d ed. 1852); NASSAU WILLIAM SENIOR, POLITICAL ECONOMY 120-24 (3d ed. 1854); 2 DUGALD STEWART, LECTURES ON POLITICAL ECONOMY 238-39, 243, 248, 250-51 (1968) (1st ed. 1855); FRANCIS A. WALKER, POLITICAL ECONOMY 606-10 (3d ed. 1888).

72. The most important Progressive and post-Progressive writing on the shifting and incidence of taxation includes: T.S. Adams, *Effect of Income and Inheritance Taxes on the Distribution of Wealth*, 5 AM. ECON. REV., May 1915, at 234 (papers & proceedings); T.S. Adams, *Federal Taxes upon Income and Excess Profits*, 8 AM. ECON. REV., May 1918, at 18 (papers & proceedings); T.S. Adams, *The Wisconsin Income Tax*, 1 AM. ECON. REV. (n.s.) 906 (1911); Harry Gunnison Brown, *Is a Tax on Site Values Never Shifted?*, 32 J. POL. ECON. 375 (1924); Harry Gunnison Brown, *The Shifting of Taxes on Sales of Land and Capital Goods and on Loans*, 29 J. POL. ECON. 643 (1921); Harry Gunnison Brown, *The Single-Tax Complex of Some Contemporary Economists*, 32 J. POL. ECON. 164, 182-89 (1924); Harry Gunnison Brown, *Some Frequently Neglected Factors in the Incidence of Taxation*, 28 J. POL. ECON. 499 (1920); Harry Gunnison Brown, *Taxing Rental Versus Taxing Salable Value of Land*, 36 J. POL. ECON. 164 (1928); T.N. Carver, *The Shifting of Taxes*, 5 YALE REV. 258 (1896); Mercer G. Evans, *The Burden of Property Taxation*, 20 AM. ECON. REV. 685 (1930); Elmer D. Fagan, *Tax Shifting and the Laws of Cost*, 47 Q.J. ECON. 680 (1932); Raymond Garver, *The Effect of Taxation on a Monopolist*, 22 AM. ECON. REV. 463 (1932); M. Slade Kendrick, *Public Expenditure: A Neglected Consideration in Tax Incidence Theory*, 20 AM. ECON. REV. 226 (1930); Sir John Lubbock, *The Income Tax in England*, 158 N. AM. REV. 150 (1894); A.C. Miller, *Note*, 1 J. POL. ECON. 450 (1892); Carl C. Plehn, *A Study of the Incidence of an Increment Value Land Tax*, 32 Q.J. ECON. 487 (1917); Edward Allsworth Ross, *Seligman's "Shifting and Incidence of Taxation,"* 3 ANNALS 444 (1892); W.H. Rowe, *The Burden of Tax Exemption of Government Bonds*, 16 AM. ECON. REV. 653 (1926); C.P. Sanger, *The Incidence of Taxation in the United Kingdom*, 6 YALE REV. 342 (1898); Seligman, *supra* note 69; Herbert D. Simpson, *The Incidence of Real Estate Taxes*, 22 AM. ECON. REV. 219 (1932); Robert H. Smith, *Distribution of Income in Great Britain and Incidence of Income Tax*, 25 Q.J. ECON. 216 (1910); *see also* 19 FINAL REPORT OF THE INDUSTRIAL COMMISSION 1031-71 (1901) (condemning the general property tax and favoring income tax); Carl C. Plehn, *Report of the Industrial Commission: IV—Taxation*, 11 YALE REV. 267 (1902) (summarizing the report).

Clearly, the economic study of tax shifting and incidence was driven by the Progressive economist's policy agenda. A tax placed on a particular person would not come out of that person's wealth if he could easily shift it to another. For example, Seligman argued that taxes on monopoly profits would fall upon the person against whom they were assessed, while taxes on competitive profits would more likely be passed on to consumers. Seligman agreed with Ricardo that a tax placed on the economic rents derived from land[73] would almost always fall upon the owner of the land. Assuming that the price of agricultural products was determined by the cost of production on marginal land, or land producing no economic rents, the effect of a tax that fell only on rents would not affect the market price. From this premise, Seligman worked out a scheme that favored taxation of monopoly receipts more heavily than the taxation of competitive receipts. As Seligman explained:

> Let us suppose that the monopolist has been selling 10,000 articles at $1.00, giving him gross receipts of $10,000, receipts which form his maximum monopoly revenue. Now a tax of ten per cent. is imposed on gross receipts. Let us assume that the monopolist will attempt to add the whole or any part of the tax to the price and charge any sum between $1.01 and $1.10. Now at any of these prices he will not get quite $10,000 gross receipts, and certainly not more than $10,000, for otherwise he would have advanced the price already before the tax. Suppose, to give him the benefit of the doubt, that he now sells $9,990 worth. Since he must pay $99.90 tax this would leave him only $9,890.10, while if he continues to charge only $1, he would still have $10,000 − $100 = $9,900. Thus it will be profitable for the producer to bear the whole burden himself. The tax cannot be shifted to the consumer, either in whole or in part.[74]

Under competition, however, a tax on gross receipts worked differently:

> In the case of competition there can be only one price in the market—the price fixed by the cost of the production of the dearest increment of the necessary supply. Now, a tax on gross receipts necessarily increases the expenses of this dearest increment. The producer at the margin of profitable production—that is, the producer whose cost fixes the price, and whose gross receipts afford him only a bare return for his outlay, without any profits—this producer must add the tax to his price, for otherwise his gross receipts, with the tax deducted, will involve him

73. That is, the difference between the commodity price and the cost of production on a particular piece of land.

74. Seligman, *supra* note 69, at 162-63 (footnote omitted). Seligman distinguished a tax on output from a tax on gross receipts. If the tax were flat across units of output, the monopolist "may, and generally will, shift the tax to the consumer." *Id.* at 161. The tax on output would raise the monopolist's marginal cost curve, thus yielding a higher profit-maximizing price and a lower profit-maximizing output, so at least part of the tax would be shifted to the consumer. But it can be shown quite easily that the amount of profit to the monopolist would decline as well. In short, the monopolist and its customers would share the burden of a tax on output.

in positive loss.[75]

Seligman concluded that under competition, part of the tax on gross receipts would be shifted, depending on the market elasticity of demand and the existence of economies or diseconomies of scale.[76] As a general rule, Seligman argued, "the degree to which a tax will be shifted on the consumer will vary inversely as [to] the elasticity of the demand, and directly as [to] the ratio of product to cost."[77] That is, the more elastic the demand for the product, the less tax could be shifted from producer to consumer. Likewise, the greater the economies of scale, the more a tax could be shifted to the consumer.[78]

Influence on American law. Seligman succeeded many times in what Progressive Era social scientists accomplished only rarely: being cited by federal courts, including the Supreme Court. The rhetoric of legal formalism generally forbad judges from citing works outside the law.[79] The titles of economic treatises appeared in the federal reports only rarely, the most frequent exception being Adam Smith's *Wealth of Nations*.

The Supreme Court, however, cited Seligman a half dozen times,[80] and the lower courts relied on his work as well.[81] The reason for his relative success was undoubtedly that Seligman's books on taxation

75. *Id.* at 163.

76. *Id.* at 163-64.

77. *Id.* at 152. Seligman explained and defended this proposition. *Id.* at 153-55.

78. *Id.* at 155.

79. On the rhetoric of legal formalism and the reluctance of substantive due process judges to cite nonlegal sources, see Hovenkamp, *The Political Economy of Substantive Due Process*, *supra* note 3, at 400-01.

80. Helvering v. Griffiths, 318 U.S. 371, 373 n.4 (1942) (citing E.R.A. Seligman, *Implications and Effects of the Stock Dividend Decision*, 21 COLUM. L. REV. 313 (1921)); Graves v. New York *ex rel.* O'Keefe, 306 U.S. 466, 484 n.4 (1939) (citing E.R.A. Seligman, *Income Tax*, in 7 ENCYCLOPEDIA OF SOCIAL SCIENCES 626-38 (E. Seligman ed. 1931)) ("That the economic burden of a tax on salaries is passed on to the employer or that employees will accept a lower government salary because of its tax immunity, are formulas which have not won acceptance by economists and cannot be judicially assumed."); United States v. Jacobs, 306 U.S. 363, 367 n.6 (1939) (citing E.R.A. SELIGMAN, ESSAYS IN TAXATION, ch. V (9th ed. 1921)); Norfolk & W. Ry. Co. v. North Carolina *ex rel.* Maxwell, 297 U.S. 682, 684 n.1 (1936) (citing E.R.A. SELIGMAN, ESSAYS IN TAXATION 283 (9th ed. 1921)); Concordia Fire Ins. Co. v. Illinois, 292 U.S. 535, 552 (1934) (Cardozo, J., dissenting) (citing E.R.A. SELIGMAN, ESSAYS IN TAXATION 161, 165, 169 (5th ed. 1921)); Indian Motorcycle Co. v. United States, 283 U.S. 570, 581 n.5 (1931) (citing E.R.A. SELIGMAN, THE SHIFTING AND INCIDENCE OF TAXATION 218, 219, 253, 254 (6th ed.)) (on the ability of a seller to shift a tax to its customers).

81. *E.g.*, DuPont v. Commissioner, 118 F.2d 544, 545 n.2 (3d Cir. 1941) (citing E.R.A. Seligman, *Income Tax*, in 7 ENCYCLOPEDIA OF THE SOCIAL SCIENCES 626 (E. Seligman ed. 1931)); *In re* Newland, 115 F.2d 165, 166 n.4 (3d Cir. 1940) (citing E.R.A. SELIGMAN, ESSAYS IN TAXATION 71, 337 (9th ed. 1921)); New Consumers Bread Co. v. Commissioner, 115 F.2d 162, 163 n.6 (3d Cir. 1940) (citing E.R.A. SELIGMAN, ON THE SHIFTING AND INCIDENCE OF TAXATION (2d ed.)); Union Trust Co. v. Commissioner, 115 F.2d 86, 87 (3d Cir. 1940) (citing E.R.A. SELIGMAN, THE INCOME TAX (2d ed. 1914)); United States v. Thomas, 115 F. 207, 213 (2d Cir. 1902) (citing Seligman, *Shifting and Incidence of Taxation*, 7 PUBLICATION AM. ECON. A. 119 (1892)); *In re* New York, S. & W. Ry., 36 F. Supp. 158, 162 (D.N.J. 1940) (citing E.R.A. SELIGMAN, THE INCOME TAX (2d ed. 1914)).

read as much like legal treatises as economic texts—they seemed to the courts to be as much "law" as "economics."

4. *The distribution of wealth and the wages question.*

The rising interest in law & economics in the late nineteenth century resulted from changes within economics. Classical political economy had always dedicated itself to the proposition that the best state is the one that governs least. Within the classical model, markets were almost always better than regulation. The classical tradition shares this premise with the 1970s law & economics movement.

What made law & economics exciting in the late nineteenth century was that the new economics appeared to challenge these presuppositions. The merging of utilitarianism and neoclassical economics suggested that legislation needed to be given a new look. Just as in taxation, the Progressive welfare economists had many scientifically derived policy proposals for labor and wealth issues. Indeed, marginal utility theory itself suggested that economists ought to be much more concerned than the classicists had been about the distribution of wealth, because egalitarian distribution tended to increase welfare.[82] Thus, the combination of marginal utility theory and diminishing returns made "distribution" an economic problem—witness the outpouring of economic literature around the turn of the century concerned primarily with the welfare effects of the distribution of wealth.[83] This problem was generally considered by later economists to be outside the bounds of economic science.[84]

The relationship between marginal value and the distribution of wealth became one of the most important debates in the first great law & economics movement. The question of who was the "residual claimant" of any economic rents that accrued during the production process provided the focus for the debate. The debate spoke to the wisdom of

82. *See* text accompanying notes 43-44 *supra*.

83. *E.g.*, THOMAS NIXON CARVER, THE DISTRIBUTION OF WEALTH (1904); JOHN BATES CLARK, THE DISTRIBUTION OF WEALTH (1927); J. COMMONS, *supra* note 42; RUFUS COPE, THE DISTRIBUTION OF WEALTH (1890); RICHARD T. ELY, PROPERTY AND CONTRACT IN THEIR RELATIONS TO THE DISTRIBUTION OF WEALTH (1914); CHARLES WILLIAM MACFARLANE, VALUE AND DISTRIBUTION (1899); JOHN K. RYAN, DISTRIBUTIVE JUSTICE (1916); CHARLES B. SPAHR, AN ESSAY ON THE PRESENT DISTRIBUTION OF WEALTH IN THE UNITED STATES (2d ed. 1896); DAVID A. WELLS, RECENT ECONOMIC CHANGES AND THEIR EFFECT ON THE PRODUCTION AND DISTRIBUTION OF WEALTH AND WELL-BEING OF SOCIETY (1891); Adams, *Effect of Income and Inheritance Taxes on the Distribution of Wealth*, *supra* note 72, at 234; James Bonar, *The Residual Theory of Distribution*, 6 Q.J. ECON. 105 (1892); T.N. Carver, *Clark's Distribution of Wealth*, 15 Q.J. ECON. 578 (1901); F.Y. Edgeworth, *The Theory of Distribution*, 18 Q.J. ECON. 159 (1904); Jacob H. Hollander, *The Residual Claimant Theory of Distribution*, 17 Q.J. ECON. 261 (1903); Francis S. Kinder, *The Effects of Recent Changes in Monetary Standards upon the Distribution of Wealth*, 4 ECON. STUD. 415 (1899); William Smart, *The Effects of Consumption of Wealth on Distribution*, 3 ANNALS 257 (1892); Philip S. Wright, *Total Utility and Consumers' Surplus Under Varying Conditions of the Distribution of Income*, 31 Q.J. ECON. 307 (1917); *see also* Arthur F. Burns, *The Brookings Inquiry into Income Distribution and Progress*, 50 Q.J. ECON. 476 (1936).

84. *See* text accompanying notes 211-226 *infra*.

wage-and-hour legislation, workers' compensation statutes, the graduated income tax—in short, the most pressing items on the welfare agenda of the Progressive Era.[85]

Much of the historical writing about the Progressive Era labor movement has emphasized the moral and political character of the arguments for regulation of wages.[86] But Progressive economists believed they were engaged in economic science. The problem, according to the marginalist utilitarians, arose from the fact that the value of the "marginal" contribution determined price. This conflicted with the older, classical notion that average contributions or costs determine price. For example, the law of marginalism suggested that capitalists seeking to hire laborers would begin with the most efficient workers and then hire marginally less efficient workers until the marginal worker just equaled his or her contribution to the production process.

Thus, as those economists often noted, only the marginal laborer, or the last laborer to be hired, received precisely his contribution to the production process. Inframarginal laborers, by definition, contributed more than their wages, assuming that all laborers were paid the same amount. This meant that laborers, among the lowest of America's economic classes, contributed more to the production process than they took out.[87]

The argument that appears so often in Progressive literature—that the worker was not getting his "fair" share—was intended as a scientific argument, the use of the word "fair" notwithstanding. The labor contracting process was lopsided and inefficient because all the bargaining power resided with the employer. Given the assumption of diminishing returns,[88] total welfare would be increased if any surplus (value in excess of marginal contribution) created by the production process was given to those who were relatively worse off. For many Progressives, this theory justified state intervention on behalf of labor, such as minimum wage laws,[89] or laws more tolerant of labor unions. In short, the Progressive economist realized that no person would stay in his current position unless he received his marginal contribution as compensation; but total welfare would be increased if any surpluses above marginal

85. *See* SAMUEL P. HAYS, THE RESPONSE TO INDUSTRIALISM: 1885-1914 (1957).

86. *E.g., id.;* S. FINE, *supra* note 33; RICHARD HOFSTADTER, THE AGE OF REFORM (1955).

87. The best statements of this argument are found in Charles A. Tuttle, *A Functional Theory of Economic Profit,* in ECONOMIC ESSAYS CONTRIBUTED IN HONOR OF JOHN BATES CLARK 321-36 (J. Hollander ed. 1927); CHARLES A. TUTTLE, OUTLINE OF COURSE IN ECONOMIC THEORY 92-93 (1894); Charles A. Tuttle, *The Workman's Position in the Light of Economic Progress,* 3 PUBLICATION AM. ECON. A. 199 (1902).

88. *See* text accompanying notes 42-44 *supra.*

89. *See* George Gorham Groat, *Economic Wage and Legal Wage,* 33 YALE L.J. 489 (1924); Leo Wolman, *Economic Justification of the Legal Minimum Wage,* 14 AM. LEGAL REV. 226 (1924). The classical position, that the wages laborers have coming are those dictated by the marketplace, was argued by Yale economist William Graham Sumner in Sumner, *Wages,* 10 PRINCETON REV. 241 (1892).

contribution were given to those who were least well-off, for their marginal utility of income was higher.

For example, Progressive John R. Commons[90] argued vehemently that unionization should operate as the mechanism by which labor could tend to recover its total contribution, just as incorporation operated as the mechanism by which individual business entrepreneurs could maximize the recovery of their marginal contribution.[91] Commons noted that a laborer's resentment of a worker who worked extra hard was no different than a seller's resentment of a price-cutter. In each case, one competitor was reducing the attractiveness of the other's offerings:[92]

> When business men call upon laborers to "produce," and criticize them for restricting production, they are calling upon them to do that which they themselves do not. For they, like the laborers, produce, not indiscriminately, but they produce in limited quantities, in order to maintain the price in their market. Their call for more product from labor is a call for labor to reduce the exchange-value of the joint product of labor and capital in that occupation.[93]

Furthermore, the capitalist deciding when to lay off laborers considers only marginal profitability. He lays off workers the instant it becomes profitable to do so, paying no attention to those workers' previous contributions to his profits.[94] For the Progressive, the developing economics of marginal utility revealed little but oppression for the working class.[95]

In neoclassical theory, the freely contracted wage, like any other bargained transaction, is Pareto superior. Neither the employer nor the laborer will strike the bargain unless he or she feels better off as a result. The same thing cannot be said of the minimum wage. The hiring of a worker at the minimum wage is Pareto superior to not hiring her at all, since the minimum wage law does not require employers to hire anyone. Even under the minimum wage law, a worker would not be hired unless he earned his contribution. But it cannot be shown that the change from a regime without minimum wage laws to a regime with such laws is a Pareto improvement. Presumably those forced to pay the higher wages are worse off, as are workers who lose their jobs when the minimum wage law takes effect.

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90. Commons initially agreed with John Bates Clark, America's most prominent theorist of marginal value at the turn of the century, that if the laborer were indeed "free"—if he could easily move from one position to another or even become a capitalist himself—then the laborer would either obtain the marginal value of his specific contribution or else capitalize it by becoming an entrepreneur. J. COMMONS, *supra* note 42, at 42-43; *see* H. HOVENKAMP, *supra* note 22.

91. JOHN R. COMMONS, LEGAL FOUNDATIONS OF CAPITALISM 283-312 (1924).

92. *Id.* at 305-06.

93. *Id.* at 306.

94. *Id.*

95. *See, e.g.*, Jacob H. Hollander, *Political Economy and the Labor Question*, 176 N. AM. REV. 563 (1903).

The debate over legal minimum wages turned Progressive Era economists' attention to the welfare effects of the "involuntary" wage agreement. This in turn raised the question whether economic welfare must be measured subjectively and individually, or objectively and socially.[96] Determining a "livable wage" by any mechanism other than the market would be considered a normative activity by most economists today. This was not so during the Progressive Era. Both liberal and centrist economists believed that one could show scientifically that the American worker required a certain minimum level of income to sustain self and family. The assumption that state policy should insist on this minimum did not appear particularly heroic. The determination of a legal minimum wage was therefore a scientific question.[97]

Determining an optimal minimum wage required the economist to apply an external, nonmarket standard of welfare to a question of public policy. A mountain of literature written during the first two decades of the century dealt with estimating the "living wage"—the minimum amount of income necessary to support a family at an acceptable standard of living.[98] Likewise, dozens of government documents and reports examined working conditions and living standards in American communities, attempting to determine the minimum living wage.[99] Glendower Evans sought to defend the development of objective criteria for a "minimum standard of living" for the woman wage earner.[100] She noted how a state wage board attempted to construct the minimum family budget—by such devices as calling "a representative connected with a department store" in order to obtain "[a]n estimate for clothing."[101] The resulting minimum weekly budget of $8.71 included ten

96. On the debate over subjective versus objective measures of welfare, see text accompanying notes 211-226 *infra*.

97. *E.g.*, A.N. Holcombe, *The Legal Minimum Wage in the United States*, 2 AM. ECON. REV., May 1911, at 21 (papers & proceedings) (discussing the mechanisms for a statistical determination of the livable wage); *see also* 2 F.W. TAUSSIG, PRINCIPLES OF ECONOMICS chs. 56-57 (3d ed. 1921) (discussing the labor issues as of that time).

98. *E.g.*, ROBERT COIT CHAPIN, THE STANDARD OF LIVING AMONG WORKINGMEN'S FAMILIES IN NEW YORK CITY (1909); LOUISE BOLARD MORE, WAGE-EARNERS' BUDGETS (1907); NATIONAL WAR LABOR BOARD, MEMORANDUM ON THE MINIMUM WAGE AND INCREASED COST OF LIVING (1918); FRANK HATCH STREIGHTOFF, THE STANDARD OF LIVING AMONG THE INDUSTRIAL PEOPLE OF AMERICA (1911); Margaret Loomis Stecker, *Family Budgets and Wages*, 11 AM. ECON. REV. 447 (1921). For critiques of the family budget approach to wage determination, see Valeska Bari, *From Minimum Wage to Mass Production*, 16 YALE REV. (n.s.) 57, 65 (1926) (arguing that although legal minimum wages were theoretically determinable through scientific analysis of cost-of-living data, in practice politics almost always intervened); Arthur Fletcher Lucas, *A Recommendatory Minimum Wage Law: The First Decade of the Massachusetts Experiment*, 14 AM. ECON. REV. 39 (1924) (citing administrative difficulties in minimum wage determination), and F.W. Taussig, *Minimum Wages for Women*, 30 Q.J. ECON. 411 (1916) (expressing skepticism about using an objective standard of living for regulating wages).

99. Some of these are summarized in Stecker, *supra* note 98, at 447.

100. Glendower Evans, *The Social Aspects of the Public Regulation of Wages*, 5 AM. ECON. REV., May 1915, at 270 (papers & proceedings); *see also* Dorothy W. Douglas, *American Minimum Wage Laws at Work*, 9 AM. ECON. REV. 701, 713, 734 (1919) (calling for an objective approach to determining a minimum wage for women).

101. Evans, *supra* note 100, at 271.

cents for "church."[102] In an article entitled *Wage Theories and Wage Policies*,[103] John R. Commons addressed the problem of objective welfare criteria and wage policy. He argued that economics since Adam Smith had properly been divided into a theory of value, which was devoted to the measurement of individual market choices; and a theory of prosperity, which was devoted to the social welfare. Public wage policy belonged to the latter. Likewise, William F. Ogburn, who would later become famous for his theory of cultural lag,[104] noted several conceptual difficulties attending any determination of a minimum standard of living enforceable by law; he advocated the approach nonetheless.[105]

The Supreme Court, on the other hand, seemed dedicated to the proposition that the legal wage was that dictated by the market.[106] By its interpretation of the fourteenth amendment to include liberty of contract and substantive due process, the Court effectively constitutionalized subjective rather than objective value preferences. Or, as Roscoe Pound and others viewed it, liberty of contract represented the judicial triumph of the subjective, individualistic doctrine of welfare over the "social" or objective doctrine.[107] The political economy of substantive due process was unwashed classicism.[108]

The Progressive Era minimum wage debate was economic at least as much as it was political. During the 1910s and 1920s, when most state minimum wage legislation was passed, the momentum in American economic theory was with those who advocated some sort of regulatory intervention in the marketplace.

5. *Institutionalism and marginalism: The Progressive critique of classical law & economics.*

Institutionalism was one of the most important intellectual achievements of the first great law & economics movement and, with marginalism, supplied one of the greatest critiques of classical economics. Institutional economics concentrated heavily on the effect of legal institutions on the allocation of resources. In this respect, institutionalism is best viewed as a reaction to the rapidly increasing use of marginal analysis in early twentieth century price theory to construct a theory of

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102. *Id.* at 273.

103. John R. Commons, *Wage Theories and Wage Policies*, 13 AM. ECON. REV., May 1923, at 110 (papers & proceedings).

104. *See* WILLIAM FIELDING OGBURN, SOCIAL CHANGE WITH RESPECT TO CULTURE AND ORIGINAL NATURE (1922); *see also* Lawrence M. Friedman & Jack Ladinsky, *Social Change and the Law of Industrial Accidents*, 67 COLUM. L. REV. 50 (1967).

105. William Fielding Ogburn, *The Standard-of-Living Factor in Wages*, 13 AM. ECON. REV., May 1923, at 118 (papers & proceedings).

106. *E.g.*, Adkins v. Children's Hosp., 261 U.S. 525 (1923) (striking down minimum wage law for women); Lochner v. New York, 198 U.S. 45 (1905) (striking down maximum hours law for bakers).

107. Roscoe Pound, *Liberty of Contract*, 18 YALE L.J. 454 (1909).

108. *See* Hovenkamp, *The Political Economy of Substantive Due Process*, *supra* note 3.

industrial organization.[109] Institutionalist economics, which flourished from the 1910s through the New Deal, drew heavily from both the British classical tradition and the German Historical School, as well as from the emerging theory of cultural evolution by natural selection.[110] Institutionalism rejected the classical view that a few simple concepts could characterize all individual and institutional behavior. In particular, institutionalism flatly rejected the rationalistic psychology of self-interest that dominated both classical and neoclassical economic theory.[111] The institutionalists believed that ideology, technology, history, habit, previous investment, and lack of information or difficulty in communication drive both individual human motivation and institutional structure. According to the institutionalists, economics could not generalize about the behavior of business firms or other organizations, or even about the influence of particular sets of legal concepts such as contract or property. Each had its own motives and working rules, which required individual study. As a result, economic theory paid increased attention to specific types of institutions and even single business firms, in order to determine how they functioned as a closed system.[112] But their critique was broader; the institutionalists' approach led them to challenge and deny that absolute freedom of contract (especially the labor contract) and unrestrained private property furthered social welfare.

Marginalism seldom looks back. It focuses on incremental change and tends to disregard the effect of previous investments or commitments on legal decisionmaking. Instead, the incremental cost of getting something done a certain way, or the incremental revenue produced is important. The marginalists made a powerful point: One of the great failures of classical political economic theory was its inability to explain how price, nature and quantity of output, wages, or basic firm size are determined.[113] In classical economics, price became a rough approximation of average cost; wages seemed to be determined solely by the amount of invested capital.[114] But at the turn of the century, marginalism appeared to provide a key to all of these problems and more. The invention of as simple a concept as marginal cost was

109. *See* Thorstein Veblen, *The Limitations of Marginal Utility*, 17 J. POL. ECON. 620 (1909). Veblen argued that although marginal analysis was a useful analytic device for solving problems within the classical model, it was not a revolution in economic thinking, for marginalism was itself burdened with obsolete theories of psychology and value.

110. On the influence of natural selection, see text accompanying notes 123-127 *infra*.

111. *See* text accompanying notes 128-131 *infra*.

112. *See* Hovenkamp, *The Antitrust Movement and the Rise of Industrial Organization*, *supra* note 2, at 107-18.

113. *See* Spurgeon Bell, *Fixed Costs and Market Price*, 32 Q.J. ECON. 507 (1917) (discussing inadequacy of classical cost theory); Eliot Jones, *Is Competition in Industry Ruinous*, 34 Q.J. ECON. 473 (1920) (same); Frank H. Knight, *Marginal Utility Economics*, in 5 ENCYCLOPEDIA OF THE SOCIAL SCIENCES 357 (E. Seligman ed. 1931); *see also* T. CARVER, *supra* note 83, at 175-82 (criticizing the classical "cost of production" theory of wages).

114. On the wage-fund theory, which saw wages as a function of previously invested capital, see Hovenkamp, *The Political Economy of Substantive Due Process*, *supra* note 3, at 431-37.

necessary to make modern price theory and industrial organization possible.

The institutionalists did not reject marginalism as a general principle. Commons himself was an innovator in marginal utility theory.[115] But they did reject marginal analysis as a complete explanation of firm behavior. For economists such as Commons and Thorstein Veblen, it was equally important to consider an organization's prior commitments, hierarchy, and other aspects of its structure.

The half century old debate about whether business firms really maximize profits[116] is nothing more than a dispute about the role of marginal analysis in price theory. Marginal analysis works only on the premise of profit or utility maximization. Concepts such as the monopolist's "profit-maximizing price," determined by equating marginal cost and marginal revenue, followed naturally from the marginalist's assumptions. However, if firms are responsive to other kinds of considerations, such as human irrationality, then marginalist price theory must become far more complex if it is to retain its predictive power. Likewise, if firms are faced with prior contractual commitments, informal obligations, or information asymmetry, then simple marginalist models can no longer predict what price a firm will charge, how large it will grow, or what its output mix or labor policies will be.

The evolution of common law rules. An important part of the 1970s law & economics movement has been devoted to the presumed efficiency of the common law. The common law, according to the arguments of 1970s law & economics, may be more efficient than legislation for two reasons: (1) the common law is designed to give effect to private bargains with minimum active interference from the state—i.e., the common law tracks the market and markets are more efficient than other forms of resource allocation; and (2) common law rules tend to become precedential only to the extent that they are efficient—i.e., through an evolutionary process, more efficient rules are upheld while less efficient ones are overruled.[117]

115. Principally, in J. COMMONS, *supra* note 42.

116. The debate became famous in 1932 with the publication of ADOLF BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). In fact, the debate stretched back much earlier. *See* Hovenkamp, *The Classical Corporation in American Legal Thought*, *supra* note 3, at 1681-84.

117. P. RUBIN, *supra* note 4, at 3-35; *see* LAW, BIOLOGY AND CULTURE: THE EVOLUTION OF LAW (M. Gruter & P. Bohannan eds. 1983); George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977); Paul H. Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977); R. Peter Terrebonne, *A Strictly Evolutionary Model of Common Law*, 10 J. LEGAL STUD. 397 (1981); *see also* RICHARD R. NELSON & SIDNEY G. WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE (1982); Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238 (1981); John C. Goodman, *An Economic Theory of the Evolution of Common Law*, 7 J. LEGAL STUD. 393 (1978); William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235 (1979). For critiques, see Richard A. Epstein, *The Social Consequences of Common Law Rules*, 95 HARV. L. REV. 1717 (1982); Richard A. Epstein, *The Static Conception of the Common Law*, 9 J. LEGAL STUD. 253 (1980); *The Inefficient Common Law*, 92 YALE L.J. 862 (1983) (student author).

The theory that legal rules evolve by a process something like natural selection was not developed in the 1970s, but at the turn of the century and even earlier in a number of works about the evolution of legal institutions.[118] Many of these early evolutionary models from the 1880s and earlier are Lamarckian instead of "economic" in that they are built around some notion of transcendent direction of an evolutionary process planned in advance.[119] For example, in an 1882 article entitled *Political Economy and Criminal Law*, Francis Wharton, one of the most prolific American law treatise writers of the nineteenth century, argued that legislators and judges tend to follow and adopt the best prevailing rules of political economy in defining business crimes. "In determining 'what is manifestly against the public good,' the common law has had often to apply to a kindred science, political economy . . . ."[120] For example, the mercantilist crimes of forestalling, engrossing, and regrating were generally abolished when mercantilist economic theory gave way to classicism in the early nineteenth century.[121]

An evolutionary model may be described as "economic" when it is based on a concept of scarcity. The model of evolution by natural selection as Charles Darwin developed it in 1859[122] was really an economic model concerning how nature allocates scarce resources. Within

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118. *See generally* Herbert Hovenkamp, *Evolutionary Models in Jurisprudence*, 64 TEX. L. REV. 645 (1985).

Some American classical economists in the late nineteenth century applied the doctrine of natural selection broadly. Thus, for example, Yale's Social Darwinist Arthur Twining Hadley argued that all kinds of social institutions gradually "evolve" to reflect greater economic efficiency. Hadley, *Ethics as a Political Science*, 1 YALE REV. 301 (1893). Richard T. Ely, another believer in the evolution of economic institutions, argued that being hardy in the evolutionary sense does not connote moral superiority—morality is merely that which separates humankind from the lower organisms. *See* RICHARD T. ELY, STUDIES IN THE EVOLUTION OF INDUSTRIAL SOCIETY 133-49 (1903); Richard T. Ely, *Competition: Its Nature, Its Permanency, and Its Beneficence*, 2 PUBLICATION AM. ECON. A. (ser. 3) 55 (1901).

119. On John Baptiste Lamarck and his evolutionary model, which was developed early in the nineteenth century, see Hovenkamp, *Evolutionary Models in Jurisprudence*, *supra* note 118, at 648-49.

Examples of essentially Lamarckian theories of legal evolution are SIR HENRY S. MAINE, ANCIENT LAW: ITS CONNECTION WITH THE EARLY HISTORY OF SOCIETY AND ITS RELATION TO MODERN IDEAS (6th ed. 1876), and FREDERICK CARL VON SAVIGNY, OF THE VOCATION OF OUR AGE FOR LEGISLATION AND JURISPRUDENCE 11, 30, 182-83 (A. Hayward trans. 1831); *see* PETER STEIN, LEGAL EVOLUTION: THE STORY OF AN IDEA 69-98 (1980); E. Donald Elliott, *The Evolutionary Tradition in Jurisprudence*, 85 COLUM. L. REV. 38 (1985); Michael H. Hoeflich, *Savigny and His Anglo-American Disciples*, 37 AM. J. COMP. L. 17 (1989).

120. Francis Wharton, *Political Economy and Criminal Law*, 3 CRIM. L. MAG. 1 (1882). Judge Posner's model of common law evolution is Lamarckian in this sense as well. He argues that common law rules are efficient because wise judges have tended over the long run to select efficient rules. *See* P. Rubin, *supra* note 117, at ix; R. POSNER, *supra* note 6, at 328, 351-53.

121. Wharton, *supra* note 120, at 3; *see also* Humer Hoyt, *The Economic Function of the Common Law*, 26 J. POL. ECON. 167, 179-92 (1918) (arguing that the common law contributes stability to the businessman's calculations, enabling him to rely on what is proven to work, and that this greatly enhances economic efficiency); D. Hughes Parry, *Economic Theories in English Case Law*, 47 LAW Q. REV. 183, 194-202 (1931).

122. CHARLES DARWIN, THE ORIGIN OF SPECIES BY MEANS OF NATURAL SELECTION: OR THE PRESERVATION OF FAVOURED RACES IN THE STRUGGLE FOR LIFE (1859).

Darwin's model, organisms produce many more offspring than their environment can accommodate. Organisms must then compete with each other for available food or other life support. Only those best qualified to survive have offspring of their own. These offspring tend to have those same characteristics that enabled their parents to beat the odds.

The economic theory of evolution by natural selection has an obvious cultural analogue. Human ideas are offered to society in numerous contexts: technological, scientific, literary, and legal, among others. Ideas that "work"—that are more aesthetically pleasing, more life or time saving, more successful at winning wars or waging peace, or more attractive in some other way—are circulated from one person or culture to the next. Less successful ideas are forgotten. They stay in the pockets of their creators "like bad pennies," as Progressive sociologist and sometimes economist Edward A. Ross said in 1901.[123]

The Darwinian theory produced a large school of followers in cultural anthropology[124] and other social sciences.[125] Many of these wrote about the evolution of legal rules.[126] Writing on "Law & Economics" in 1925, John R. Commons expressly identified the economic approach to the study of common law rules as Darwinian: "[F]rom the economist's approach, the common law is a special case of Darwin's 'artificial selection,' by the courts in this instance, of what are deemed to be good customs, and the rejection and penalization by the courts of what are deemed to be bad customs."[127]

Institutionalist economists were heavily influenced by the theory of evolution and believed that classical price theory failed to account for the evolutionary aspects of institutional development.[128] Institutional rules tend to survive when they enable members of some group to

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123. EDWARD ALSWORTH ROSS, SOCIAL CONTROL 345 (1901).

124. *See, e.g.*, LEWIS HENRY MORGAN, ANCIENT SOCIETY (1877); EDWARD TYLOR, PRIMITIVE CULTURE (1889); *see also* Hovenkamp, *Evolutionary Models in Jurisprudence*, *supra* note 118, at 657-59.

125. *E.g.*, AUGUST DRÄHMS, THE CRIMINAL (1900) (criminology, physiology, sociology, psychology); E. ROSS, *supra* note 123 (sociology); LESTER F. WARD, DYNAMIC SOCIOLOGY: OR APPLIED SOCIAL SCIENCE (1883) (economics, sociology); *see also* JOHN A. HOBSON, EVOLUTION OF MODERN CAPITALISM: A STUDY OF MACHINE PRODUCTION (1894). On the influence of Darwin on American thought outside the biological sciences, see PAUL F. BOLLER, JR., AMERICAN THOUGHT IN TRANSITION: THE IMPACT OF EVOLUTIONARY NATURALISM, 1865-1900 (1969); RICHARD HOFSTADTER, SOCIAL DARWINISM IN AMERICAN THOUGHT (1955); EDWARD A. PURCELL, JR., THE CRISIS OF DEMOCRATIC THEORY: SCIENTIFIC NATURALISM AND THE PROBLEM OF VALUE (1973); CYNTHIA EAGLE RUSSETT, DARWIN IN AMERICA: THE INTELLECTUAL RESPONSE, 1865-1912 (1976); MORTON G. WHITE, SOCIAL THOUGHT IN AMERICA: THE REVOLT AGAINST FORMALISM (1949); PHILIP P. WIENER, EVOLUTION AND THE FOUNDERS OF PRAGMATISM (1965).

126. *E.g.*, EVOLUTION OF LAW: SELECT READINGS ON THE ORIGIN AND DEVELOPMENT OF LEGAL INSTITUTIONS (A. Kocourek & J. Wigmore eds. 1915-1918); EDWARD ALLSWORTH ROSS, SIN AND SOCIETY (1907); E. Ross, *supra* note 123; W. Jethro Brown, *Law and Evolution*, 29 YALE L.J. 394 (1920); Arthur L. Corbin, *The Law and the Judges*, 3 YALE REV. 234 (1914); A.G. Keller, *Law in Evolution*, 28 YALE L.J. 769 (1919). *See generally* JOHN H. BECKSTROM, EVOLUTIONARY JURISPRUDENCE (1989); Hovenkamp, *Evolutionary Models in Jurisprudence*, *supra* note 118.

127. John R. Commons, *Law and Economics*, 34 YALE L.J. 371, 372 (1925).

128. *See* text accompanying notes 123-126 *supra*.

maintain or increase their welfare, argued Thorstein Veblen in *The Theory of the Leisure Class*.[129] In this sense, institutionalism was an attempt to make classicism dynamic. Classicism and neoclassicism dealt with economic decisions as if time and historical commitment counted for nothing.[130] People switched from one thing to another whenever the marginal value of the shift was positive. Businesses immediately abandoned one production process or organizational structure when a more efficient one appeared. Institutionalism, by contrast, maintained that people's institutional commitments were stronger and more complex than classicism assumed. Disentanglement took time, and there were many obstacles that needed to be overcome. As a result, the given classical model of price theory could not account fully for the existence or development of institutions except perhaps over the extraordinarily long run.[131]

In one important characteristic, the 1970s law & economics movement views legal evolution differently than did the Progressive Era movement. The 1970s movement has been devoted mainly to the evolution of common law rules to the exclusion of legislation. In fact, some have argued that the common law is more efficient than legislation because the common law has experienced this evolutionary process, while legislation has not.[132] A variant is that efficient rules are selected through the adjudication process rather than the legislative process.

The nature of the 1970s evolutionary argument generally reflects a bias in favor of the common law that was not present in the law & economics movement of the Progressive Era. The bias at that time tended, if anything, to favor legislation, although some of the most evolutionary Progressive Era thinkers, such as Roscoe Pound, were ambivalent toward legislation and tended to prefer common law rules, at least for the

129. THORSTEIN VEBLEN, THE THEORY OF THE LEISURE CLASS: AN ECONOMIC STUDY OF INSTITUTIONS ch. V (1899); *see also* THORSTEIN VEBLEN, THE PLACE OF SCIENCE IN MODERN CIVILIZATION AND OTHER ESSAYS 444 (1961); Abram L. Harris, *Economic Evolution: Dialectical and Darwinian*, 42 J. POL. ECON. 34 (1934).

130. The leading American theorist of static marginalism was John Bates Clark, who developed an analytic model in which "population neither increases nor diminishes . . . capital is fixed in amount . . . the method of making goods does not change," and "the wants of consumers never vary in number, in kind, or in intensity." JOHN BATES CLARK, ESSENTIALS OF ECONOMIC THEORY AS APPLIED TO MODERN PROBLEMS OF INDUSTRY AND PUBLIC POLICY 132 (1907).

131. *See* Morris A. Copeland, *Commons's Institutionalism in Relation to Problems of Social Evolution and Economic Planning*, 50 Q.J. ECON. 333, 335 (1935). Charles S. Ashley called for the use of evolutionary theory by political economists, particularly for more analysis of the role of trial and error in human decisionmaking. Charles S. Ashley, *Relation of Evolution to Political Economy*, 44 POPULAR SCI. MONTHLY 458 (1894). *See generally* JOHN R. COMMONS, INSTITUTIONAL ECONOMICS (1934); John R. Commons, *Institutional Economics*, 21 AM. ECON. REV. 648 (1931).

132. *See* R. POSNER, *supra* note 6, at 495 ("Although the correlation is far from perfect, judge-made rules tend to be efficiency-promoting while those made by legislatures tend to be efficiency-reducing.") (footnotes omitted). For a critique, see P. RUBIN, *supra* note 4, at 53-57.

adjudication of private disputes.[133] But by and large, Progressives identified legislation with experiment, and experiment with evolutionary progress.[134] Although the common law evolved, it changed much too slowly to be an effective social control device, particularly where the public interest was concerned.[135]

Thorstein Veblen and the creation of institutionalism.[136] Thorstein Veblen was an outcast from nearly every institution with which he was associated. Too much a renegade to be accepted by conventional neoclassicists, his academic life depended on the grace of a few powerful liberals. Much of his life he was unemployed.[137] However, Veblen's work[138] contained the seeds of institutionalism.

Veblen began this critique and became prominent among economists[139] in 1898 with an attack on neoclassicism entitled *Why is Economics not an Evolutionary Science?*[140] He argued that while true science was "evolutionary," neoclassical economics was not because it was formalistic, "taxonomic," and "tautological." Economics, Veblen argued, should be evolutionary in the same way that the rest of human culture is. Above all else this meant that it must be historical, experimental, and empirical. Neoclassicism, on the other hand, sought to create a logical system whose rules never changed; for this reason, it was doomed to irrelevance.

In *The Theory of Business Enterprise*,[141] Veblen dealt with the problems of technology, economies of scale, and natural rights, principally liberty of contract. The problem of law & economics was that business had developed a technology and form of organization in which coordina-

133. *See* Hovenkamp, *supra* note 118, at 680 & n.197. *Compare* Roscoe Pound, *Do We Need a Philosophy of Law?*, 5 COLUM. L. REV. 339, 353 (1905), *with* Roscoe Pound, *Common Law and Legislation*, 21 HARV. L. REV. 383, 406-07 (1908).

134. *See e.g.*, E. ROSS, *supra* note 123.

135. *Cf.* Pound, *Common Law and Legislation*, *supra* note 133, at 406-07 (common law applies old principles, while legislative experimentation applies new principles).

136. On the institutional critique of law and economics, see Commons, *supra* note 127; John R. Commons, *The Problem of Correlating Law, Economics and Ethics*, 8 WIS. L. REV. 3 (1932); Colin A. Cooke, *The Legal Content of the Profit Concept*, 46 YALE L.J. 436 (1937); Eugene Allen Gilmore, *The Relation of Law and Economics*, 25 J. POL. ECON. 69 (1917) (describing the death of intellectual interaction between students of law and students of economics at leading universities); Mark M. Litchman, *Economics, the Basis of Law*, 61 AM. L. REV. 357 (1927); Donald R. Richberg, *Economic Illusions Underlying Law*, 1 U. CHI. L. REV. 96 (1933); Edwin R.A. Seligman, *Social Aspects of Economic Law*, 5 PUBLICATION AM. ECON. A. 49 (1904); *see also* Ralph F. Fuchs, *The Newer Social Scientists Look at Law*, 13 ST. LOUIS L. REV. 33 (1927).

137. For biographical information on Veblen, see JOSEPH DORFMAN, THORSTEIN VEBLEN AND HIS AMERICA (1934); DAVID RIESMAN, THORSTEIN VEBLEN: A CRITICAL INTERPRETATION (1953); *see also* DAVID SECKLER, THORSTEIN VEBLEN AND THE INSTITUTIONALISTS: A STUDY IN THE SOCIAL PHILOSOPHY OF ECONOMICS (1975); BEN B. SELIGMAN, MAIN CURRENTS IN MODERN ECONOMICS 129-58 (1962).

138. *See* text accompanying notes 139-148 *infra*.

139. He became prominent among the general public a year later with the publication of T. VEBLEN, THE THEORY OF THE LEISURE CLASS, *supra* note 129.

140. Thorstein Veblen, *Why Is Economics Not an Evolutionary Science?*, 12 Q.J. ECON. 373 (1898).

141. THORSTEIN VEBLEN, THE THEORY OF BUSINESS ENTERPRISE (1932).

tion and standardization were essential, but were often frustrated by the law's elaborate protections for individual rights. The legal theory of individual rights, Veblen argued, antedated modern business enterprise and grew out of a regime in which households were self-contained economic entities.[142] Further, the legal theory of natural rights treated people as equals, while modern business organization required a hierarchy.[143] Veblen argued that the efficiency of the modern business organization dictated the hierarchical structure, but legal doctrines such as liberty of contract, used to strike down wage-and-hour laws, effectively left the hierarchy unregulated. The result was that the worker effectively relinquished his freedom to private power, and state power was unavailable to assist him.[144]

In *Absentee Ownership*,[145] Veblen dealt with the greatest efficiency producing engine of the capitalist economy: the market. The modern capitalist market was a forum in which goods could be exchanged even though the goods themselves were located elsewhere or still to be produced. Importantly, recognition of such a market required legal recognition of absentee ownership, or the notion that one had a right to property not in his immediate physical control. This concept, Veblen argued, explained both the greatness and the weakness of modern capitalism. With the "transition to the machine industry and factory system," absentee ownership became the rule rather than the exception, and owners became "investors."[146] This led to the separation of ownership and control and an attendant lack of accountability. This lack of accountability justified more intensive regulation by the state.

Veblen was too far outside the mainstream to have much immediate influence on American economics. However, his work was seminal in the development of institutional economics in the 1920s and 1930s.[147] Veblen, likewise, had only modest influence on the judiciary. In his dissenting opinion in *Liggett Co. v. Lee*, Justice Brandeis cited Veblen's *Absentee Ownership* together with Berle and Means' *The Modern Corporation and Private Property* for the proposition that ownership of the modern corporation had become separated from its control, reducing corporate accountability and justifying more elaborate regulation.[148]

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142. *Id.* at 129-30.

143. *Id.*

144. *Id.* at 133-34.

145. THORSTEIN VEBLEN, ABSENTEE OWNERSHIP AND BUSINESS ENTERPRISE IN RECENT TIMES: THE CASE OF AMERICA (1923).

146. *Id.* at 55-56.

147. *See* text accompanying notes 136-146 *supra*.

148. Liggett Co. v. Lee, 288 U.S. 517, 565 (1933) (striking down a state statute taxing most chain stores at higher rates than single store firms) (Brandeis, J., dissenting) (footnotes omitted):

> Ownership [in the modern business corporation] has been separated from control; and this separation has removed many of the checks which formerly operated to curb the misuse of wealth and power. And as ownership of the shares is becoming continually more dispersed, the power which formerly accompanied ownership is becoming increasingly concentrated in the hands of a few. The changes thereby wrought in the

Ely and Commons. In addition to Veblen, the most important institutionalists in the Progressive Era law & economics movement were Richard T. Ely of the University of Wisconsin and his student John R. Commons. Both wrote comprehensive books on law & economics, as well as several articles. Each had an important influence on the economic theories of his own day and those of the subsequent generation, although their influence waned in the 1940s and after. The influence of institutionalism on American law, principally from 1930 to 1970, remains unexplored, but circumstantial evidence indicates that it was substantial.[149]

Richard T. Ely. Ely, like many of the Progressive reformers, grew up in an evangelical Protestant family and had his orthodoxy challenged by a post-Darwinian liberal education in America and Europe.[150] His evangelical zeal turned into a desire for social reform.[151] Along with most of the prominent Progressive economists, Ely studied economics in Germany and was exposed to the German Historical School.

He became prominent in 1884 when, as an assistant professor at Johns Hopkins University, he wrote a long diatribe against British classical economics.[152] Simon Newcomb, an orthodox classicist at the same university, responded in kind.[153] Then began one of the most tempestuous debates in American economic theory, etching lines so clear that almost no American economist or social scientist could straddle them.[154] The principal issue was whether belief in laissez-faire was necessary to qualify one as an economist.[155] The institutionalists identified themselves with the more statist approach of the marginalists to solving problems of the day. An early product of the debate was the emergence of the American Economic Association in 1885. This new association provided an institutional alternative for academic economists who

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> lives of the workers, of the owners and of the general public, are so fundamental and far-reaching as to lead these scholars to compare the evolving "corporate system" with the feudal system; and to lead other men of insight and experience to assert that this "master institution of civilised life" is committing it to the rule of a plutocracy.

On the problem of separation of ownership and control in the history of corporate regulation, see Hovenkamp, *The Classical Corporation in American Legal Thought*, *supra* note 3, at 1672-88.

149. *See* text accompanying notes 159-197 *infra*.

150. On Ely's life, see RICHARD T. ELY, GROUND UNDER OUR FEET: AN AUTOBIOGRAPHY (1938); B. RADER, *supra* note 33.

151. *See* ROBERT M. CRUNDEN, MINISTERS OF REFORM 12-14 (1982).

152. Richard T. Ely, *The Past and the Present of Political Economy*, 2 JOHNS HOPKINS U. STUD. HIST. & POL. SCI. 143-202 (1884).

153. Simon Newcomb, *The Two Schools of Political Economy*, 14 PRINCETON REV. (n.s.) 291 (1884).

154. Other contributions to the debate include WILLIAM GRAHAM SUMNER, COLLECTED ESSAYS IN POLITICAL AND SOCIAL SCIENCE (1885); Richard T. Ely, *Recent American Socialism*, 3 JOHNS HOPKINS U. STUD. HIST. & POL. SCI. 231-304 (1885). For more on the debate, see MARY O. FURNER, ADVOCACY & OBJECTIVITY: A CRISIS IN THE PROFESSIONALIZATION OF AMERICAN SOCIAL SCIENCE, 1865-1905, at 60-80 (1975); B. RADER, *supra* note 33, at 30-35; Hovenkamp, *The Antitrust Movement and the Rise of Industrial Organization*, *supra* note 2, at 109-15.

155. *See* A.W. Coats, *The Political Economy Club: A Neglected Episode in American Economic Thought*, 51 AM. ECON. REV. 624 (1961).

wished to show some distance from the British classical tradition.[156]

Ely devoted much of his career to examining the social role of private property and the legal rules protecting it. His work is characterized by a tension between recognition of the need for private ownership, which he believed necessary for prosperity, and awareness of the social need to regulate private property in order to prevent it from becoming a source of structural oppression by the wealthy. As Ely put it in 1894,

> [t]his social theory of private property justifies a regulation of its use; but it must be always borne in mind that if this regulation is carried far, the advantages of private property begin to disappear. When it becomes necessary to regulate private property minutely, we have a clear indication that private property should be replaced by public property.[157]

Ely believed that the state could control private property without regulating it "minutely" through the common law of property and contract. They were the optimal alternatives to socialism.

Ely's most ambitious venture into law & economics was his 2-volume *Property and Contract in their Relations to the Distribution of Wealth.*[158] Ely began with the premise that both private property and private contract were socially beneficial, but there were limits to which private ownership should be carried. He was, of course, writing as a preordinalist; he believed that interpersonal comparisons of utility were possible, and that total welfare generally became greater when wealth was more evenly distributed.

In the institutionalist tradition, Ely argued that the distribution of wealth in society was a product of previously created legal rules, not merely that of the natural laws of economics. Running throughout the two volumes of *Property and Contract* is a single theme: Unregulated bargaining enhances power that already exists and creates increasingly greater economic inequality.[159] The law of contract

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156. *See* Richard T. Ely, *The Founding and Early History of the American Economic Association*, 26 AM. ECON. REV. 144 (1936) (papers & proceedings); *see also* A.W. Coats, *The First Two Decades of the American Economic Association*, 50 AM. ECON. REV. 555 (1960).

157. R. ELY, SOCIALISM, *supra* note 33, at 309.

158. R. ELY, *supra* note 83.

159. Ely appears to be criticizing the position taken by John Bates Clark, who had argued in 1899 that in a perfectly functioning market, each contributor to the production and distribution process would receive precisely his marginal contribution—no more and no less. Clark opposed labor unions as an attempt by workers to obtain more than their marginal contribution. *See* J. CLARK, *supra* note 83, at v:

> [T]he distribution of the income of society is controlled by a natural law, and . . . this law, if it worked without friction, would give to every agent of production the amount of wealth which that agent creates. However wages may be adjusted by bargains freely made between individual men, the rates of pay that result from such transactions tend . . . to equal that part of the product of industry which is traceable to the labor itself. . . . At the point in the economic system where titles to property originate,—where labor and capital come into possession of the amounts that the state afterwards treats as their own,—the social procedure is true to the principle on which

> tends to preserve advantages once secured, because the inequalities or disadvantages under which one party may labor will express themselves in contract. And as contract tends to preserve advantages secured, so it continues disadvantages—contract tends to keep the existing condition of things, or to allow existing currents to flow on. . . . The strong want unregulated contract; they are the economic conservatives. The reform forces must advocate regulation of contract.[160]

Marginal analysis did not cope with this problem any better than classicism, for marginal desire always reflects the present distribution of wealth and legal entitlements.

Ely objected to any notion that the law of contract is "natural" and thus justifies the economic inequality that might result from a regime of unregulated contracting. Rather, "*[t]he state itself is the source of contract* . . . ."[161] Nonetheless, Ely believed that private bargaining could continue to be efficient. He doubted that state regulation could substitute for large areas of contract. Rather, state interference should be designed to account for differences in strength of bargaining position, and thus stem the flow of wealth from the poor to the wealthy and powerful.[162]

Though his work is filled with moral rhetoric, Ely believed that his proposals were economically efficient for society as well.[163] For a preordinalist Progressive economist, such interference with liberty of contract was justified on economic grounds. Total welfare would be increased, other things being equal, when wealth was distributed more evenly. The combination of the existence of unequal bargaining power and unrestrained liberty of contract made unregulated contract itself inefficient for society: Wealth would shift to the wealthy, for whom the marginal utility of money was relatively low, away from the poor, who valued it highly.

Progressive Era social science literature often argued that unregu-

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> the right of property rests. So far as it is not obstructed, it assigns to every one what he has specifically produced.

See also John B. Clark, *The Law of Wages and Interest*, 1 ANNALS 43 (1890); John B. Clark, *Possibility of a Scientific Law of Wages*, 4 PUBLICATION AM. ECON. A. 37 (1889). Clark apparently believed that these laws were natural. *See* J. CLARK, *supra* note 130, at 451 ("The law of marginal productivity works, as it were, *in vacuo*, and gives an ideally perfect result.").

160. 2 R. ELY, *supra* note 83, at 579-80.

161. *Id.* at 579 (italics in original).

162. *Id.* at 586-618; *see also* John B. Clark, *Capital and Its Earnings*, 3 PUBLICATION AM. ECON. A. 81 (1888). The notion that the widespread existence of bargaining power justified state intervention in contract became a prominent feature of the *Restatement (Second) of Contracts* and 1960s case law. The leading case is Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965). *See* GRANT GILMORE, THE DEATH OF CONTRACT 99-101 (1971); STUDIES IN CONTRACT LAW 12 (E. Murphy & R. Speidel 3d ed. 1984); Mary Ann Glendon, *The Transformation of American Landlord-Tenant Law*, 23 B.C.L. REV. 521 (1982).

163. The laissez-faire judges of the Supreme Court had also used essentially moral language to give effect to the policy views of the classical economists when they struck down wage-and-hour legislation. *See* Hovenkamp, *The Political Economy of Substantive Due Process*, *supra* note 3, at 412-20.

lated markets tend to concentrate wealth in the hands of a few.[164] Therefore, the state should intervene to correct the imbalance caused by inequality of bargaining position. Absolute liberty of contract might seem to be efficient in a world in which interpersonal comparisons of utility are impossible. However, state interference to "equalize" bargaining power might be welfare enhancing in a regime which made such comparisons by external measures of welfare. This thesis reemerged in the early New Deal literature of corporate control, where Berle and Means argued that the unregulated business corporation tended to shift wealth from society generally into the hands of a relatively small number of owners.[165] The perceived duty of courts in this scheme was not to engage in the positive redistribution of wealth. Rather, recognizing that law is a product of state policy rather than of nature, their obligation was to ensure that legal rules did not become a device for further increasing the maldistribution, thereby reducing social welfare.

Ely believed that the "essential purpose of all private property is the general welfare,"[166] and that more even distribution generally had positive welfare effects. But this radical sounding theory nevertheless led him to relatively orthodox views about rights in private property. For example, he believed that compensation should be paid when private property was taken for the public good. The state's willingness to compensate, Ely argued, tends to establish the fact that the taking *is* for the public good: If the benefit were not for the public good, the payment would give the public a reason to object.[167] Ely developed a theory of market failure justifying the state's eminent domain power, stating that eminent domain was appropriate whenever private ownership prevented property from being dedicated to its socially optimal use.[168] However, as with most economists of the material welfare school, Ely's idea of market failure encompassed inequalities of distribution as well as a market's inability to allocate resources efficiently in the potential Pareto, or Kaldor-Hicks, sense. For example, Ely suggested that the eminent domain power could be used to provide public housing for the poor.[169]

164. *E.g.*, S.G. Lindholm, *The Law of the Concentration of Property*, 13 J. POL. ECON. 267 (1904) (discussing the notion that in an unregulated, individualistic economy wealth moves toward (a) the monopolist and (b) the larger owner; thus, without state intervention, property ownership becomes ever more unequal); *see also* Edward Alsworth Ross, *The Tendencies of Natural Values*, 2 YALE REV. 173 (1893) (arguing that unregulated competition leads to a concentration of wealth in the hands of a few).

165. A. BERLE & G. MEANS, *supra* note 116, at chs. 1-2 (1932); *see also* Liggett Co. v. Lee, 288 U.S. 517, 565 (1933) (Brandeis, J., dissenting) (using this argument to advocate more active state regulation of business corporations); text accompanying notes 88-89, 148, 162 *supra*.

166. 2 R. ELY, *supra* note 83, at 477.

167. *Id.* at 484-92, 504-07.

168. *Id.* at 475-83.

169. *Id.* at 501.

Ely concluded *Property and Contract* with a long section on vested interests, which he defined as interests for which the state traditionally provided compensation when a legal taking occurred.[170] He argued that determining what kinds of interests could be vested was as much a historical, social, and cultural question as it was an economic one. At one time, economists believed that a tradesman had a vested right in his occupation and could thus exclude local competition.[171] Likewise, the legal institution of slavery created a set of vested rights, which were later removed without compensation.[172]

Ely rejected both the socialistic view that vested rights should be ignored any time their abolition tends to increase total welfare, and the conservative view that any destruction of a right previously recognized by law as vested required compensation. One of the most serious vested rights problems in the United States, argued Ely, had been the states' excessive willingness to give corporate franchises for natural monopolies or natural resources. The result was a great and generally senseless transfer of public wealth into private hands.[173] Even here, Ely believed that the sovereign should atone for past mistakes only by paying compensation. Payment of a fair price guarantees that the state will act only when a taking is indeed in the public interest.[174]

John R. Commons. Commons was more scholarly than his teacher Ely, less of a campaigner, and certainly not as much of a troublemaker in academic circles.[175] But liberalism was cut as deeply into his forehead as Ely's. He was a prominent founder of institutionalist economics, much of which he developed in writing about the law of business organizations and labor. His single most important contribution to the first great law & economics movement was *Legal Foundations of Capitalism*,[176] an economic classic by anyone's measure. *Legal Foundations* was a grand attempt to integrate the German Historical methodology into economic analysis of institutional behavior.

In *Legal Foundations of Capitalism*, Commons developed the theory of the "going concern," which was both an economic and legal institution. To Commons, the going concern was far broader than the business firm commonly identified in legal writing as the going concern.[177]

170. *Id.* at 755.
171. *Id.* at 768-69.
172. *Id.* at 800-08.
173. *Id.* at 780-87.
174. *Id.* at 785.
175. On Ely's problems with academic institutions, see M. FURNER, *supra* note 154, at 87-89, 90-92, 100-01, 115-24, 252-55. On Commons, see JOHN R. COMMONS, MYSELF (1934).
176. J. COMMONS, *supra* note 91.
177. The notion of the going concern became an important part of the institutionalist law & economics developed during the 1920s and 1930s by people such as Wesley Mitchell, Walton Hamilton, and Karl Llewellyn. *E.g.*, Walton Hamilton, *The Institutional Approach to Economic Theory*, 9 AM. ECON. REV., May 1919, at 316 (papers & proceedings); Walton Hamilton, *Law and Economics*, 19 AM. ECON. REV., May 1929, at 56 (papers & proceedings); Karl Llewellyn, *The Effect of Legal Institutions upon Economics*, 15 AM. ECON. REV. 665 (1925); Karl H. Llewellyn, *What Price Contract?—An Essay in Perspective*, 40 YALE L.J. 704 (1931); Wesley C. Mitchell,

Business firms, governments, families, and charitable and nonprofit organizations could all be going concerns under Commons's definition. Commons believed that nature and economy rather than the law created going concerns. Although perceived as a "creature" of the law, all the law had really done to the business corporation was to take a form of association that had evolved from economic necessity, recognize it, and give it certain advantages, such as limited liability, in order to encourage its development.

The going concern saw distribution within the concern as governed by the concern's own "working rules," not by rules governing market transactions. The going concern had assets and liabilities as a single entity, just as an individual person did. Agreements, exchanges, or decisions within the concern were governed by these "working rules," and Commons styled these decisions "transactions."[178] External markets were just one of many alternative mechanisms for clearing "transactions." A market transaction was distinctive only in that the market itself was an institution, having its own working rules. Thus every individual participated in a large number of institutions, or going concerns, and transactions within each of these institutions were governed by unique sets of working rules.[179] The common law itself was a set of working rules for society.[180]

Although the concept of the going concern was not limited to business organizations, Commons devoted considerable attention to the business firm. An important difference between the institutionalist economic tradition and the alternative neoclassical tradition[181] is whether marginal cost is merely a factor or the only factor in determining firm size and nature. For strict neoclassicists such as Ronald Coase, marginal costs of using the market determined the scope of the business firm. But the institutionalists disputed the notion that marginalism could answer every important question about the organization of any institution, including the business firm. Firms make commitments to certain structures. Those commitments, once made, affect future decisions even if the decisionmaker engages in nothing but marginal analysis. Once an institution developed its working rules, its investment in those rules became a factor in future decisions:

> [T]he collective will [of the going concern] is also guided by acts of participants in the past. Customs, practices, habits, precedents, meth-

Commons on Institutional Economics, 25 AM. ECON. REV. 635 (1935); Wesley C. Mitchell, *Commons on the Legal Foundations of Capitalism,* 14 AM. ECON. REV. 240 (1924); *see also* Lionel D. Edie, *Some Positive Contributions of the Institutional Concept,* 41 Q.J. ECON. 405 (1927); Abram L. Harris, *Types of Institutionalism,* 40 J. POL. ECON. 721 (1932).

178. J. COMMONS, *supra* note 91, at 67-68. Commons defined transaction as "an active relation between parties having both the economic dimensions of opportunity and power and the legal dimensions of reciprocal rights, duties, etc., which arise from the working rule to which the transaction belongs." *Id.* at 121 n.1.

179. *Id.* at 83.

180. *See* Commons, *Institutional Economics, supra* note 131, at 651.

181. *See, e.g.,* R.H. Coase, *The Nature of the Firm,* 4 ECONOMICA (n.s.) 386 (1937).

> ods of work, have been built up and handed down as working rules, which limit discretion in the present. Binding contracts, informal agreements, understandings, resolutions of stockholders, perpetuate the working rules of the past in the behavior of the present. The articles of incorporation, the contracts with bondholders, go back still further and bind more firmly the present and future acts of will.[182]

Commons's institutional theory of the firm and Coase's neoclassical theory also differed in that Commons recognized "managerial transactions," or transactions within the going concern, as fundamentally different from "bargaining transactions," which were market transactions between separate individuals or going concerns. Coase's nature of the firm, on the other hand, treated the two as economic substitutes for each other. Whether the firm would employ a bargaining transaction (by procuring an input on the market) or a managerial transaction (by making the input for itself) was simply a matter of which one was cheaper under the circumstances.[183]

For Commons, institutional "working rules" determined the firm's size and structure. Cost was only one of these rules. More importantly for policy, managerial transactions required more legislative supervision than bargaining transactions, for managerial transactions were hierarchical and the effects of prior commitment were much greater. The law had always recognized this, Commons noted. For example, the common law had developed a law of master and servant that was much more interventionist than the law of contracts generally, even though the relationship between employer and employee was contractual.[184] To economists like Commons, the problem with the Supreme Court's decision in *Lochner v. New York*[185] and similar cases was that they treated managerial transactions as nothing but a species of contract. The result was that a "liberty" that presumed equality of bargaining position was applied inappropriately to a hierarchical relationship as well.

Commons's distinction between managerial and bargaining transac-

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182. J. COMMONS, *supra* note 91, at 147. Compare this with O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM, *supra* note 9, at 131-62.

Commons also argued at some length that goodwill should be taken far more seriously in the economics of business organizations than it had been in the past. J. COMMONS, *supra* note 91, at 161-65, 191-99. The tendency among economists had been to evaluate business as the cost of the plant plus other physical assets, together with a few intangible assets. But this narrow definition failed to distinguish the plant from the firm, or going concern. The going concern is a product of many previous decisions, not merely the investment in physical assets that may make it either more valuable or less valuable than the firm's other assets. Even a firm's bargaining power is an asset that would have an exchangeable value when the firm was sold. *Id.* at 164, 168. The value of a firm is its assets, which are "the expected additions to income to be derived, not from physical things, but from expected profitable transactions with persons who are not owned." *Id.* at 168; *see also* John R. Commons, *Political Economy and Business Economy*, 22 Q.J. ECON. 120 (1907).

183. *See* Commons, *supra* note 136, at 10 (making clear that Commons regarded neoclassical economics' failure to recognize the distinction between these two types of transactions as an important weakness).

184. *Id.*

185. 198 U.S. 45 (1905) (voiding maximum hours regulation for bakers).

tions helps explain one of the most important attributes of the great economic policy debate between conservatives and Progressives at the turn of the century. Both classicists and conservatives perceived wage bargains simply as a species of contract that should be governed by normal contractual rules.[186] The Progressives, on the other hand, viewed labor law as something fundamentally different from contract law because of its inherent hierarchical nature; therefore, the labor contract required much more regulation than contracts generally.

In Commons's theory of the going concern lay an important insight into why economies and governments work poorly. Going concerns have their own working rules, Commons noted, whose principal objective is to further their own interests. The chief problem with Adam Smith's theory that the "invisible hand" of the marketplace would maximize social wealth was that Smith believed that the relevant decisionmaker was the individual, and the interests of individuals weighed more or less equally in policymaking. But Smith never considered the possibility that certain institutions, by suppressing the market mechanism, could come to yield power disproportionate to the numbers they represented. The result was to skew legislative policymaking, judicial policymaking, and even the private bargaining process.[187] Once again, the result of institutional power was welfare-reducing wealth transfers from poor to rich.

Even Adam Smith suspected that institutions could distort the market's mechanisms for allocating resources, Commons noted. Smith's concept of the invisible hand would have allocated resources optimally in relation to the value placed on them by each individual. "Yet this mechanistic economy of nature, as Smith sorrowfully acknowledged, has been greatly interfered with by the collective power of political and industrial governments."[188] As a result, Smith would have abolished

> all corporations and associations, because they restricted the liberty of the individual by majority vote, and would reduce government to the

186. *See generally* Hovenkamp, *Labor Conspiracies in American Law, 1880-1930*, *supra* note 3.

187. *See generally* JOHN R. COMMONS, THE ECONOMICS OF COLLECTIVE ACTION (1950) (published posthumously). An almost exclusive concern with the impact of interest groups on legislative policymaking differentiates recent "public choice" theory from Commons's institutionalism. "Public choice" theory particularly emphasizes market failures in the legislative process, created through such devices as lobbying, which can influence legislatures to pass legislation that is not in the best interest of society as a whole. Commons's notion of the going concern as an interest group defined "interest group" as a power capable of influencing judicially created rules and private arrangements as well as legislation. *See* Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873 (1987); Herbert Hovenkamp, *Legislation, Well-Being, and Public Choice*, 57 U. CHI. L. REV. — (1990) (forthcoming).

188. J. COMMONS, *supra* note 91, at 323. By "political and industrial governments," Smith meant all institutions in a position to affect the allocation of economic resources. These included governments, business corporations, unions and other organizations. *See generally* JOHN R. COMMONS, WILLIS WISLER, ALFRED P. HAAKE, O.F. CARPENTER, JENNIE MCMULLIN TURNER, ETHEL B. DIETRICH, JEAN DAVIS, MALCOLM SHARP & JOHN A. COMMONS, INDUSTRIAL GOVERNMENT (1921) (analyzing methods of government used in individual industries).

> lowest terms of maintaining security. There would then ensue a "natural" economy, instead of an "artificial" political economy, which would operate through nature's laws of free competition, demand and supply. This nature-economy is indeed fundamental, and cannot be escaped. . . . But it has greatly been interfered with by collective power exercised through working rules by those who controlled the mechanism and the supply. Instead of abolishing associations as desired by Adam Smith, the weakness of the individual has driven him into corporations and unions, while governments have yielded and have granted to these associations sovereign powers and immunities from sovereign power, until they are far more powerful than those condemned by Adam Smith and the French Revolution.[189]

The labor union was nothing more than a counterbalance to the business firm's power. Commons argued that there was no basis for the legal distinction between the business firm as a single entity and the labor union as a combination of laborers.[190] What does the laborer sell? Certainly not himself; for the thirteenth amendment would forbid it. He or she sells a certain amount of added value to the production process, contributing just what the firm itself contributes in the way of raw materials, distribution, etc. Importantly, the laborer can aggregate what he sells in precisely the same way. Therefore, the union should be looked at as a "firm" selling a certain quantity of labor, just as the manufacturing company sells its product. Courts were misled by the fact that laborers are individual entities which have conspired to withhold their labor. Commons criticized American law for treating the incorporated business firm as a single "person," having both property rights and constitutional rights, including the right to contract, while treating unincorporated labor unions as associations of individuals.[191] The business corporation

> appears in court as a single individual rather than an association of individuals who have combined their property into a unit, with an industrial government, with limited liability and with corporate immortality; whereas the union appears as a conspiracy of individuals, holding conventions, without property, and merely inflicting damage on property by withholding the supply of labor until the terms of the contract can be agreed upon.[192]

The courts' legal distinction between corporations and unions did not accord with the economic fact that both unions and firms were institutions selling property. "[I]f labor is property, it would seem that associated labor is also property," Commons complained.[193] Further,

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189. J. Commons, *supra* note 91, at 385-86.

190. Commons developed this point at length in J. Commons, *supra* note 187, at 25-35.

191. On the constitutional personhood of the business corporation, see Hovenkamp, *The Classical Corporation in American Legal Thought*, *supra* note 3, at 1640-50.

192. J. Commons, *supra* note 91, at 296. On the problem of "conspiracy" and incorporation of labor unions during the Progressive Era, see Hovenkamp, *Labor Conspiracies in American Law, 1880-1930*, *supra* note 3, at 958-62.

193. J. Commons, *supra* note 91, at 296.

> the right to act together as an industrial government is a property right, and . . . the property need not be tangible coal mines, but is the expectation of income to be obtained through bargaining power and apportioned to its members according to rules agreed upon, an expectation similar to the goodwill of a business.[194]

Coercion and organized coercion were thus two-way streets, but the American law of business firms and conspiracy failed to recognize this. Commons approved of Justice Brandeis's conclusion in Hitchman Coal case: "If it is coercion to threaten to strike unless plaintiff [employer] consents to a closed union shop, it is coercion also to threaten not to give one employment unless the applicant will consent to a closed non-union shop."[195]

Commons argued that, while the modern business firm was for the most part a marvelous engine of efficiency, it used labor inefficiently because the firm could easily shift costs away from itself and on to laborers. For example, although the manufacturing of steel was much less labor intensive than a generation earlier and worker productivity had increased by a factor of five, the mills had moved from an eight hour day to a twelve hour day despite evidence that the workers were exhausted and individually worked less efficiently when required to work twelve hours.[196] The workers had to be paid a subsistence wage whether they worked eight hours daily or twelve—thus the marginal cost to the employer of the twelve hour day neared zero. Although worker efficiency was lower under a twelve hour day, the worker would still do more in twelve hours than in eight. Had the labor union been permitted by law to wield its institutional power to the same degree that the manufacturer wielded its power, worker efficiency might have been increased as well.

Commons concluded with this argument for increased state supervision of private bargaining:

> It is often charged against legislation that the state does not create wealth—only private activity is wealth-producing. The charge is, of course, true. Legislation only classifies activities and proportions the inducements to wealth-producers. Individuals do the rest. But so might it be said of other economies. Economy is merely proportioning the factors by limiting some and expanding others. Yet the total product of the combined factors is enormously increased if the best possible proportioning is obtained . . . . The business man's principal business is not that of working with his hands, but is that of proportioning the different kinds of work, materials and machines . . . . So it is with legislation and judicial decision. They do nothing but proportion inducements, and individuals do the rest. But they may waste the commonwealth by bad proportioning, may enlarge it by good

194. *Id.*

195. *Id.* at 297 (quoting Hitchman Coal & Coke Co. v. Mitchell, 245 U.S. 229, 271 (1917) (Brandeis, J., dissenting)).

196. J. COMMONS, *supra* note 91, at 322.

proportioning.[197]

Institutionalism played a prominent part in economic theory and law & economics until the late 1930s, when Ronald Coase's path breaking article on firm behavior[198] argued that the determinants of business firm size and structure could be found entirely within neoclassical price theory. Coase assumed the same rationalistic psychology that the institutionalists had rejected—in this context, that the business firm's overriding motive is to maximize its profits.[199] According to Coase, a firm grows when it provides for itself something that it would otherwise have had to purchase on the market. Both expansion into such new areas and resort to the market are costly, but the costs of each vary from one situation to the next. A firm maximizes profits by minimizing costs. As a result, Coase argued, cost alone dictates whether a firm will expand to provide something for itself.[200] Given this premise, neoclassical price theory could explain fully why a firm integrates vertically, organizes a process in a particular fashion, moves into a new area of enterprise, or has a particular labor policy. This neoclassical orientation toward industrial organization overwhelmed institutionalist economics in the 1940s and after.[201] Only recently has institutionalism experienced a resurrection, particularly in the writing of Oliver Williamson.[202]

III. Part II: The Economic Revolutions That Both Facilitated and Undermined Progressive Law and Economics

During the Progressive Era, social scientists strove to be recognized as professionals, just as the practitioners of harder sciences had done during the previous century. Professional status required a defensible methodology, and the method of the day was first empiricism, then positivism. The positivist revolution proved to have remarkable implications for the practice of law & economics.

A. *Behaviorism: Objective and Subjective*

Early behavioral psychologists, such as J.B. Watson, believed that one thing kept psychology from becoming a truly positive science: One person could not measure another person's thoughts or feelings in the way that a physicist or geologist measures time or a botanist describes plants. Behaviorism enabled a science of psychology despite the im-

197. *Id.* at 329-30.

198. *See* Coase, *supra* note 181; Hovenkamp, *The Antitrust Movement and the Rise of Industrial Organization*, *supra* note 2, at 120-22.

199. *See* Coase, *supra* note 181.

200. *Id.* at 401-03.

201. For a good critique of institutionalism by a thoughtful neoclassicist see Frank Hyneman Knight, *The Limitations of Scientific Method in Economics*, in THE TREND OF ECONOMICS 227 (R. Tugwell ed. 1924).

202. *E.g.*, O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM, *supra* note 9.

possibility of verifying the thought processes of another. Since we cannot verify or measure another's thoughts or perceptions, argued Watson, we use the next best thing: external responses. Earlier psychologists, such as William James, had suggested introspection as a device for studying human behavior.[203] Watson rejected introspection as a basis for the science of psychology. The scientist's own perception that he or she would respond in a certain way to a certain stimulus could never be generalized to society in a way that would yield predictable results.[204] Behavioral psychology was thus much more "social" than introspective psychology, for the behaviorist attempted to generalize responses over large groups.

Positive economics in the 1920s and 1930s also became affected by behaviorism, but not in the same way as psychology. Psychology tended to distrust people's statements about how they felt, looking instead to objective external manifestations of those feelings. Positive economics did precisely the opposite. It purported to measure "welfare" entirely by how individuals spent their dollars in observed market transactions; not by how prosperous they appeared to be, or whether they were educated, employed, housed, clothed, or even fed. Market transactions are indeed "external manifestations" of desire; however, the positive economist would look *only* at those external manifestations of welfare. In short, psychology and the other social sciences adopted objective tests of adjustment or welfare that were capable of being generalized over large groups. The psychologist could no more experience another person's pain than the economist could experience and measure another's satisfaction. But the essence of scientific psychology for the behaviorist lay in finding surrogates that could be measured and generalized over large groups of people. The positive economist refused to accept any surrogates for welfare other than voluntary market transactions. The behaviorist believed she could talk about pain more "scientifically" than the introspectionist even though the introspectionist perceived pain—her own—directly, while the behaviorist perceived only screams, electrical impulses, convulsions, or other external responses that she was willing to classify as pain. Thus, Amartya Sen was not entirely joking when he told the story about two behaviorists who meet each other on the street one day. One said to the other, "I see you are very well. How am I?"[205]

Several economists argued in the 1920s that measuring economic welfare required objective tests drawn from behavioral psychology or

203. *See* 1 WILLIAM JAMES, PRINCIPLES OF PSYCHOLOGY 185 (1890) (arguing that the psychologist relies on introspection "first and foremost and always"); *see also* Jared S. Moore, *Behavior versus Introspective Psychology*, 30 PSYCHOLOGICAL REV. 235 (1923); Margaret Floy Washburn, *Introspection as an Objective Method*, 29 PSYCHOLOGICAL REV. 89 (1922).

204. *See* JOHN B. WATSON, BEHAVIORISM 5 (1930) (Introspection yields "as many analyses as there are individual psychologists. There is no way of experimentally attacking and solving psychological problems and standardizing methods.").

205. AMARTYA SEN, CHOICE, WELFARE AND MEASUREMENT 72 (1982).

sociology. In 1920, Princeton's Frank Fetter argued that economists should distinguish "price economics" from "welfare economics"—the former based on subjective individual valuation, the latter based on objective standards of value drawn from observations of group behavior.[206] Fetter attributed the distinction to Alfred Marshall, who was obsessed with the problem of forcing economics to deal with real human welfare while maintaining its status as an exact science.[207] "Price economics applied to life" simplifies economic models and makes exactness possible, Fetter conceded, "but it does so by leaving out much (often all) that is of real importance to the individual life and to the social welfare."[208] A few years later, Wesley Mitchell likewise conceded that social welfare was a "rather vague" concept. However, "it is capable of being made objective and definite in reference to such matters as food, clothing, shelter, sanitation, education, fatigue, leisure."[209] Yale's Irving Fisher suggested in 1927 that by using statistics and large amounts of empirical data one could construct averaged utility curves for families of different income levels, thereby measuring their welfare objectively. Such a method could be made sufficiently reliable to enable policymakers to construct, for example, an optimal progressive income tax.[210]

B. *Positivism and Ordinalism*

The redistributive premises of the material welfare school and the first great law & economics movement were rejected in the 1930s, when a new generation of economists called the ordinalists argued that economic welfare could mean only observed subjective choices. The ordinalists argued that any attempt to make quantitative comparisons of one person's welfare with that of another would involve economists in unscientific interpersonal comparisons of cardinal utilities.[211] Economics was "behaviorist," but only in the sense that it relied on one person's observations of the subjective preferences of others under conditions of scarcity. The ordinalists refused to sanction comparisons of even the broadest aggregations of humans or their needs.

Positivist economics' unique approach to behaviorism was facilitated by a new definition of economic science. For the classicists and most of the neoclassicists, economics had been principally a science of wealth. For the ordinalists, the group of positivistic economists who

206. Frank A. Fetter, *Price Economics versus Welfare Economics*, 10 AM. ECON. REV. 467 (1920).

207. Frank A. Fetter, *Price Economics versus Welfare Economics: Contemporary Opinion*, 10 AM. ECON. REV. 719, 719-23 (1920).

208. *Id.* at 736.

209. Wesley Clair Mitchell, *The Prospects of Economics*, in THE TREND OF ECONOMICS 1, 31 (R. Tugwell ed. 1924).

210. Fisher, *supra* note 54, at 157. On the Progressives and tax policy, see text accompanying notes 48-67 *supra*.

211. *See, e.g.*, L. ROBBINS, *supra* note 55.

began writing in the 1930s, economics became a science of scarcity. The difference is important.[212]

Classical economics dealt with the various mechanisms by which people tried to accumulate "wealth," which was perceived as an objective category. At least in nonborderline cases, observers could agree as to what constituted "wealth."[213] In order to be part of wealth, something had to be both useful and exchangeable.[214] This explains the great interest of the early marginalists in such questions as the distribution of wealth, the relationship between cost and demand, the relationship between utility and value, and the definition of the kinds of commodities with which economics could be concerned.

Lionel Robbins, one of the first positivist critics of the material welfare school, defined economics as a science of measuring individual human response to scarcity.[215] Under this definition the concept of "wealth" had no objective meaning. Wealth was nothing more than a reflection of individual choice in the marketplace.

For example, suppose the state creates a taxation scheme that forces *A*, a wealthy person, to pay annually a sum of money to feed, clothe, house, and educate *B*, who is quite poor. *A* once or twice annually expresses annoyance at being taxed, but the tax is a small portion of his income. His standard of living appears to be unchanged; nothing about his life or lifestyle, measured externally, seems to change very much as a result of this tax. On the other hand, before this taxation scheme had come into existence, *B*, who was poor and uneducated, had experienced frequent starvation and illness and great anxiety about her own situation and that of her family. After she began receiving the tax payments, *B* was able to feed and clothe her family and go to school, and her expressions of anxiety disappeared.

On the above facts both the behaviorist psychologist and the behaviorist sociologist could draw some "scientific" conclusions about the social effects of the tax program. But positivist economists of the 1930s would draw no scientific conclusions about whether the transaction increased or decreased economic welfare. The external manifestations of pain or pleasure were not the kind of evidence from which the economist could measure changes in welfare. From the above facts, one cannot determine whether the utility that *A* subjectively assigned to what he gave up was less than or greater than the utility that *B* subjectively assigned to what she received. Without such information, the positivist economist argued, any conclusion about whether the forced wealth transfer increased "welfare" was purely ethical or normative—or, as

212. *See* Robert Cooter & Peter Rappoport, *Were the Ordinalists Wrong About Welfare Economics?*, 22 J. ECON. LITERATURE 507 (1984).

213. *See, e.g.*, Mitchell, *supra* note 209, at 31.

214. *See* L.M. FRASER, ECONOMIC THOUGHT AND LANGUAGE 23 (1937).

215. *See* L. ROBBINS, *supra* note 55, at 12-16, 151-52.

Robbins put it, "lacking in scientific foundation."[216] The difference was not that the methodology of the economist was scientific, or "positive," while the method of psychology was not, for the psychologist's method was also positivistic. Rather, the difference was that the psychologist used objective external manifestations of well-being to measure "desire" or "welfare." The economist measured "welfare" by subjective market choices, so-called "revealed preference."[217]

The positive economists conceded that for a given individual, the utility curve of any product or even of money itself slopes downward. As a result, the amount of pleasure produced by the tenth dollar is less than the amount produced by the first dollar.[218] However, given two individuals, *A* and *B*, there is no way to compare the amount of pleasure that *A* receives from his first dollar with the amount *B* receives from her first or her tenth dollar. For any given person, the law of diminishing returns might apply, but utilities cannot be quantified and compared from one person to another. Hence the term "ordinalist": Individual utilities can be ordered, in the sense that it could be said that *A* values *X* more than *Y*, but they cannot be quantified in any sense that permitted comparison of the amount of utility one person had with the amount that someone else had.

Writing during the heyday of positivism in philosophy and the natural sciences,[219] Robbins argued that questions about interpersonal comparisons of utility were not scientific at all. *A* may know the amount of utility he receives from his first dollar and his tenth. Likewise, *B* may know her own utility. An outside observer, however, knows only what *A* and *B* actually say about their utility. Further, *A*'s utility is entirely subjective, as is *B*'s. As Robbins put it:

> [S]uppose that we differed about the satisfaction derived by *A* from an income of £1000, and the satisfaction derived by *B* from an income of twice that magnitude. Asking them would provide no solution. Suppose they differed. *A* might urge that he had more satisfaction than *B* at the margin. While *B* might urge that, on the contrary, he had more satisfaction than *A*. We do not need to be slavish behaviorists to realize that here is no scientific evidence. *There is no means of testing the magnitude of A's satisfaction as compared with B's.* If we tested the state of their blood-streams, that would be a test of blood, not satisfaction. Introspection does not enable *A* to measure what is going on in *B*'s mind, nor *B* to measure what is going on in *A*'s. There is no way of comparing the satisfactions of different people.[220]

As a result, concluded Robbins, "[t]he conception of diminishing rela-

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216. *Id.* at 141.

217. *See* Paul A. Samuelson, *Consumption Theory in Terms of Revealed Preference*, 15 ECONOMICA 242 (1948).

218. *See* L. ROBBINS, *supra* note 55, at 136-41.

219. On the influence of positivism on the first ordinalists, see WILLIAM H. BEVERIDGE, THE LONDON SCHOOL OF ECONOMICS AND ITS PROBLEMS, 1919-1937, at 46-58 (1960).

220. L. ROBBINS, *supra* note 55, at 139-40 (emphasis in original).

tive utility . . . does not justify the inference that transferences from the rich to the poor will increase total satisfaction. It does not tell us that a graduated income tax is less injurious to the social dividend than a non-graduated poll tax."[221]

Robbins's statement about blood tests reveals an important difference between positive economics and positive behaviorist psychology. The positive economist refused to accept even the broadest and most obvious welfare surrogates for purposes of measurement. Robbins's essay, like the work of most positivists, was dedicated to improving economic "science" by removing morals or ethics from economics. The apogee of economic positivism came with Milton Friedman's famous 1953 essay, *The Methodology of Positive Economics*.[222] Economic science, Friedman argued, consists of formulating hypotheses and then attempting, through empirical observation, to falsify them. Hypotheses cannot be "tested" merely by examining the basic plausibility of their assumptions or their logical consistency.[223] Theories are meaningful only insofar as they are verified or falsified by observable data. Hypotheses that cannot be verified or falsified empirically are simply not scientific statements.

Many of Friedman's ideas were not new, but had been developed more than a half century earlier in the debate between the American classicists and the younger economists who followed the German Historical School.[224] In 1884, Johns Hopkins economist Simon Newcomb wrote about the "two schools" of political economy, criticizing his young colleague Richard T. Ely for relying too heavily on historical rather than formal methodology.[225] Newcomb argued that the human mind is not complex enough to account for every cultural phenomenon or quirk of human behavior. The mind needs a theory that strips most of these away, even if the theory itself seems "unrealistic" when compared with what appears to be happening in the real world. The only purpose of a theory is to make predictions:

> all science is from its very nature founded on hypothesis. The expression of a law of nature is merely an assertion that under certain circumstances a certain result will be produced. So far as the law is

221. *Id.* at 141.

222. MILTON FRIEDMAN, *The Methodology of Positive Economics*, in ESSAYS IN POSITIVE ECONOMICS 3 (1953).

223. *See* KARL R. POPPER, THE LOGIC OF SCIENTIFIC DISCOVERY (1935 & English trans. 1959); *see also* KARL R. POPPER, THE POVERTY OF HISTORICISM (1957); Imre Lakatos, *History of Science and Its Rational Reconstructions*, in 8 BOSTON STUDIES IN THE PHILOSOPHY OF SCIENCE 91 (R. Buck & R. Cohen eds. 1971); Imre Lakatos, *Proofs and Refutations*, 14 BRIT. J. PHIL. SCI. 1-25, 120-39, 221-43, 296-342 (1963-1964). In economics, see Herbert Simon, *Problems of Methodology—Discussion*, 53 AM. ECON. REV., May 1963, at 229 (papers & proceedings).

224. On the German Historical School, see text accompanying note 12 *supra*. Many of Friedman's ideas also reflected the work of the Vienna Circle, or the logical positivists, who believed that the meaning of an assertion is nothing more than the method by which it could be verified or falsified. *See, e.g.*, ALFRED JULES AYER, LANGUAGE, TRUTH AND LOGIC (1936).

225. Simon Newcomb, *The Two Schools of Political Economy*, 14 PRINCETON REV. (n.s.) 291 (1884).

> concerned the circumstances may or may not exist; they may even be such as never did exist without at all impairing the validity of the law.[226]

The views of the positive economists in this early debate won the day. Later economists could ignore the interventionist proposals of the material welfare school, for these were not based on information that the ordinalists accepted as scientific.

1. *Ordinalism, welfare, and the market.*

Once one accepts the ordinalist strictures on economics, the welfare consequences of most involuntary wealth transfers become indeterminate. In the wake of Robbins's critique of interpersonal comparisons of utility as a basis for welfare measurement, economists turned to the presumably more testable but much more restrictive concept of Pareto superiority. Under Paretianism, a state policy may be said to increase welfare only if at least one person subjectively perceived that he benefitted and no one subjectively perceived that she was injured.[227] Even the most uncontroversial state policies injure someone, however.[228] The switch from interpersonal comparisons of utility to Paretianism as the basis for welfare economics meant that very few involuntary wealth transfers could be said to increase welfare on acceptably "scientific," or economic, grounds.

Voluntary market exchanges, on the other hand, were always Pareto superior, provided that no third parties were affected by the transaction. A seller would not sell for a given amount unless he valued the object sold at less than the price; likewise, the buyer would not pay unless she valued the object at more than the price.

The ideological impact of ordinalism can be seen in the reconstruction of welfare economics after Robbins's critique of the material welfare school. Orthodox Paretianism could not offer a suitable basis for examining welfare change. Any change that improved the lot of some people but injured others had indeterminate welfare effects, and the great majority of changes fall into this category.

In the late 1930s Nicholas Kaldor and John R. Hicks attempted to increase the usefulness of ordinalist welfare economics for policy analysis through the development of the "potential" Pareto criterion—sometimes known as "Kaldor-Hicks efficiency."[229] Under this criterion a change increases welfare if the gainers from the change are able to compensate the losers fully for their losses and still have something left

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226. *Id.* at 295.

227. *See, e.g.*, VILFREDO PARETO, COURS D'ECONOMIE POLITIQUE (1896-1897).

228. *E.g.*, passing a statute against child molesting is not Pareto superior, for potential child molesters will believe themselves worse off.

229. *See* J.R. Hicks, *The Foundations of Welfare Economics*, 49 ECON. J. 696 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Inter-Personal Comparisons of Utility*, 49 ECON. J. 549 (1939).

over. Whether such compensation is actually paid is irrelevant, because the criterion is not concerned with how wealth is distributed, but only with how much of it there is.

Under ordinalism, the ideology of neoclassical welfare economics moved very far to the right. For the ordinalist, voluntary transactions could be scientifically shown to enhance welfare. Forced wealth transfers generally could not be, and came to be perceived as reflecting nothing more than politics. Unless explained by a testable market failure, such transfers were generally bad.[230] This is where ordinalist economics drew the line between "positive," or scientific, and merely "normative" analysis.

2. *Did the ordinalist critique improve economic science?*

Progressive economists, unlike later post-New Deal economists, could consider as a scientific issue the possibility that a dollar transferred to the poor from the wealthy might increase total welfare. Within their science, such transfers, objectively measured across groups, seemed to increase social welfare.

One result of the ordinalist revolution is that a contemporary economist can look back on Progressive welfare economists and dismiss their redistributive aspects and methodology as not a part of economic science at all. A good example of this is Ely's *Property and Contract in Their Relations to the Distribution of Wealth.*[231] An ordinalist would have two reasons for proclaiming Ely's book outside the realm of economic science. First, it is concerned principally with the distributive consequences of property and contract rather than with their consequences for Pareto efficiency. Second, Ely's methodology is heavily historical and anecdotal. There is almost no building of models or systematic use of data to falsify a model once developed.

Thus the question "What is economics?" looms large in any decision about whether there was a "first" law & economics movement. Some would say that the principal concerns of the Progressive Era economists who wrote about law were not "economic" at all. As a result, what they were doing was not "law & economics."

This essay accepts the notion that questions about what belongs inside or outside a particular science are fundamentally contextual: The boundaries of a science always depend on the questions one asks and the problems that appear to need solution. To that extent, the answers are largely rhetorical and reflect the ideology of those providing them. Whether a particular writing is "economic" must be determined by the conventions of its own day. The work of Ely, Commons, Seligman, and

230. Government intervention to correct market failure might be justified on economic grounds, as in the case of price regulation of a natural monopoly, but in such cases the declared purpose of the intervention is something other than the transfer of wealth. Rather, it is to mimic a market transaction in which the market failure would not occur.

231. R. ELY, *supra* note 83.

other Progressives dedicated to studying "welfare" in the preordinalist sense was clearly "economic" at the turn of the century, whatever its status today.

Economic positivists, like Robbins, believed that economics was entitled to call itself a science only if it could separate fact from value, and they believed this was possible. Verifiability (or falsifiability) became their stated criterion for characterizing a proposition as scientific. What could not be verified or falsified, such as the proposition that *A* obtains more utility from an additional dollar than *B*, was simply not part of economic science.

But the constraints that Robbins imposed on welfare economics are subject to several objections. First, all forms of empirical inquiry require assumptions that can be neither verified nor falsified. For example, eighteenth and early nineteenth century geologists and paleontologists realized this truth during the great debate between the catastrophists and the uniformitarians. Some catastrophists argued that the laws of nature had not always been constant, but had permitted much greater rates of change in the past than today. As a result, the world gives evidence that it is much older than it really is. The idiosyncratic, evangelical genius Philip Gosse queried in *Omphalos*, would someone examining Adam in the Garden of Eden have found a navel?[232] Undoubtedly yes. Adam looked like other men. Suppose the same observer had cut down the Tree of Knowledge. Would it have displayed rings? Almost certainly yes. The line of argument was clear. Just as the freshly created earth contained people with navels but no mothers and trees with rings but no past, so too it undoubtedly contained limestone, coal and oil, even though we know these to be composed of the remains of creatures who died long ago. One who came upon the freshly created earth would find evidence of considerable age. The uniformitarians did not bother themselves with such arguments—not because they could prove their critics wrong, but because even entertaining their assumptions made science impossible. No one could ever prove historical uniformitarianism. It was simply one of those propositions that people had to accept in order to make scientific model building possible.

Robbins's conclusion that *A* could not compare *B*'s pleasure with his own was a simple observation about the private nature of the human mind. Each person knows only her own mind and not that of others, that is why interpersonal comparisons of individual utility are impossible. But this line of reasoning is irrelevant to the question of establishing uniform utility functions across large groups of people. If taken seriously, it proves much more than Robbins tried to prove or would

232. PHILIP HENRY GOSSE, OMPHALOS: AN ATTEMPT TO UNTIE THE GEOLOGICAL KNOT (1857). On the debate over geologic uniformitarianism, see HERBERT HOVENKAMP, SCIENCE AND RELIGION IN AMERICA: 1800-1860, at chs. 5, 6, 7 (1978); C.C. GILLESPIE, GENESIS AND GEOLOGY (1951).

have been willing to accept. For example, just as *A* cannot compare *B*'s pleasure with his own, so too he cannot compare *B*'s sensory perceptions with his own. *A* can only ask *B* what *B* saw, and *A* must rely on language rather than participation in *B*'s perceptions to conclude that he and *B* in fact saw the same thing. One can never verify that *A* and *B* have the same perceptions; one can verify only that they use the same words to describe them. How does Robbins know that *A* can never determine whether *B* is experiencing more pleasure than *A* is? Robbins knows this because he perceives that he cannot know for sure. But can he really know whether or not *A* knows? He knows only what *A* tells him.

In 1925, Chicago economist Frank Knight, one of the most thoughtful observers of the positivist revolution, spoke of the difference between "observation" and "inference." He noted that

> [i]n discussing the problem of economic demand it was pointed out that science regards our knowledge of the desires of any person except ourselves as an inference from behavior of some sort—speech, gesture, facial expression, and the like. Consciousness is not an observed fact, but, like force in mechanics, a "convenient" assumption . . . and cannot be admitted as a scientific datum. But reflection makes it clear not only . . . that we "infer" force, and the consciousness of other persons, from our own consciousness, but that we cannot perceive the objects themselves as real without making this inference to a certain extent, without reading our own experience into them.[233]

Knight concluded, agreeing with the psychologists:

> The answer at the end of every line of inquiry is instrumentalism. Reality is not what is logical, but what it suits our *purposes* to treat as real.
>
> . . . .
>
> And always, the test for distinguishing "real" observation from imaginary . . . is the possibility of verification, which means comparison with the communicated observations of other persons. Observation in the scientific sense is therefore restricted to the limits of possible communication . . . .[234]

Economists, like other scientists, accept without proof the existence of other minds and the reliability of communications of agreement be-

233. Frank H. Knight, *Economic Psychology and the Value Problem,* 39 Q.J. ECON. 372, 394-95 (1925).

234. *Id.* at 396-98; *see also* Frank H. Knight, *Fact and Metaphysics in Economic Psychology,* 15 AM. ECON. REV. 247, 252, 255 (1925):

> The possibility of securing agreement is an absolutely essential feature of the scientific criterion of truth. Truth is not merely what is the same for all, but is what is known and recognized as the same. Exponents of the scientific logic commonly take this process of demonstration or verification for granted in an unpardonably uncritical fashion. . . . Before an observation can count as such it must be communicated, discussed, and compared with the communicated observations of other persons.

Id. at 252. Carried to its logical conclusion, Knight's argument was that the existence of others' minds is something that the individual cannot "verify" in any sense that positivist methodology considered acceptable. But Knight did not push the point.

cause this and only this gives science utility.[235] In the process, however, "they do not suspect that they have gone over bodily from a realistic to a teleological philosophy!" Knight concluded that "subjective idealism and scientific realism finally split on the same rock, the common-sense impossibility of disbelieving in the reality of other minds."[236]

Economics' most important postulate—that people (or firms) behave rationally so as to maximize their own utility is itself unverifiable as a general proposition. About the best that we can do is to make some observations consistent with the proposition, although there seem to be others that are inconsistent. One might, of course, postulate an alternative—that economics should treat people and firms *as if* they behaved rationally, whether or not they do in fact—but this is at once a normative rather than positive doctrine and would lie outside the bounds of economic science as the positivists defined it.[237]

As Robbins's ordinalist critique suffers on its own and on behaviorist terms, so does the reconstruction of welfare economics driven by his ideas. For example, Kaldor-Hicks assumed that the marginal utility of income is constant for an individual (while the marginalists assumed it declined) and constant from one person to another.[238] But, the Kaldor-Hicks criterion is unscientific as the positivist defines the term. First, as a premise about the amount of satisfaction a dollar creates in one person or another, the Kaldor-Hicks criterion requires an interpersonal comparison of subjective welfare precisely like the one made by welfare economists. The fact that compensation is not actually paid under the Kaldor-Hicks criterion renders it impossible to conclude that a Kaldor-Hicks improvement is actually an improvement in welfare without such an assumption.[239]

A second problem with the Kaldor-Hicks efficiency criterion is that, to the extent we have any information at all about individual utilities, it seems that the marginal utility of income declines—that is, individual *A* values her millionth dollar less than her first dollar. Even if everyone had the same utility curve, a wealth transfer would be welfare neutral only if the parties were equally wealthy, given that each individual has declining marginal utility for money. A transfer from rich to poor would increase welfare, while one from poor to rich would reduce it.[240]

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235. Knight, *supra* note 234, at 254.

236. *Id.* at 255.

237. *See* AMARTYA SEN, *Rational Fools: A Critique of the Behavioural Foundations of Economic Theory*, in CHOICE, WELFARE AND MEASUREMENT 84, 91 (1982).

238. *See* Cooter & Rappoport, *supra* note 212, at 507, 526 (noting that Kaldor-Hicks efficiency "requires the economist to proceed as if a dollar were equally valuable to everyone").

239. *See* WILLIAM J. BAUMOL, WELFARE ECONOMICS AND THE THEORY OF THE STATE 161-70 (2d ed. 1965).

240. *See id.* at 164:

> [A]ssume that all the persons who gain from an innovation are very rich, whereas all the losers are in a highly impoverished state. Is it then reasonable to assume that the

Likewise, even if each individual experienced constant marginal utility of income—i.e., she valued her millionth dollar as much as her first—one could not assume that a wealth transfer was welfare neutral; for one individual could still place a higher (although constant) value on each dollar than another does.[241] In short, to the extent Kaldor-Hicks can be tested with respect to individual intrapersonal utility preferences, it seems to be simply false.

3. *Did the ordinalists improve law & economics?*

Some law & economics people are fond of dividing the territory of law & economics into "normative" and "positive" analysis—thereby implying that the latter is purely descriptive, or value free.[242] Wealth transfers are commonly characterized in so-called positive analysis as being welfare neutral. They are given this characterization not because they are known to be welfare neutral, but because the proposition that mere dollar transfers can increase or decrease utility is deemed not to be scientifically verifiable or falsifiable.

But nothing binds the legal policymaker to the economist's, rather than the psychologist's, criterion of welfare or definition of positive science. As a result, the welfare question is one that the legal policymaker might well wish to reconsider, regardless of the status of the question within economics. The modern concept of "allocative efficiency," which measures the total wealth of society in constant dollars, has little to do with a society's subjective welfare—its members' pain, satisfaction, or pleasure.[243] Law, unlike economics, must deal with the latter.

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subjective value of money does not vary from one group to another? Certainly the fact that the richer group has gained (in money terms) slightly more than the poorer group has lost, is meagre evidence that there has indeed been a balancing between satisfactions and dissatisfactions. Indeed, it seems very plausible that the same amount of money might well represent a much greater loss to the poorer group than the corresponding gain to the richer.

241. One might use leisure time, rather than dollars, as a measure of welfare. Although people have different amounts of wealth, all have the same amount of time per year. Suppose that a sum of money was transferred forcibly on an annual basis from Rich to Poor and that the welfare criterion were: "How many minutes of leisure time would Rich give up in order to have this money, and how many minutes would Poor give up in order to have it?" If Rich would give up only one minute, but Poor would give up fifteen minutes, then the transfer has positive "welfare" effects of fourteen minutes. Such a criterion is neither more nor less scientific than the criterion that treats all dollars as creating the same amount of welfare.

In one sense, the leisure time criterion may be better than the dollar criterion. Everyone, wealthy and poor alike, has the same number of minutes per year. Of course, this does not mean that they have the same utility for leisure. One person may like it very much and one person may dislike it. Incidentally, in making policy suggestions, economists constantly use criteria such as productivity (amount of value created per unit of time) that treat time as a constant.

The point is that using leisure time as a welfare criterion is no less scientific than using dollars, but it gives very different results to the question of whether the transfer of a single dollar from Rich to Poor is welfare neutral or welfare creating.

242. *E.g.*, R. POSNER, *supra* note 6, at 20-22.

243. This limitation is critical and undermines welfare analysis even in such expressly economic subjects as antitrust. Ever since Cournot, and in the neoclassical tradition since

Whatever their effect on economic science, the ordinalist's strictures improve law & economics only if the legal policymaker can make better use of the economist's measure of welfare than the psychologist's.

Here the behaviorist's legacy re-emerges in an important way. In the 1920s, behaviorism became the dominant social science methodology. Particularly in psychology,[244] social scientists rejected the view championed by William James a generation earlier that the psychologist must deal primarily in introspection.[245] The influence of behaviorism, however, extended beyond psychology.[246] Jurisprudence itself was among the first of the social sciences to become behaviorist; beginning in 1881 when Holmes argued in *The Common Law*[247] that those who administer the laws should not be concerned with subjective intent as such, but only with external manifestations indicating intent. The common law, Holmes argued, is not very concerned with how a person thinks or feels, but with how he acts.[248]

Consider a practical application in the role of legal policy. We can never be sure that *B* experiences more pain when we cut off his arm than *A* experiences when we pinch his nose. We can listen to *B* describe his pain, or to outside observers who tell us how *B* responds, but neither we nor *A* can experience *B*'s pain and compare it with *A*'s. We are in precisely the same position as the economist attempting to make interpersonal comparisons of utility as between *A* and *B*.

One problem of law & economics that makes objective measures of welfare essential is that law deals mainly with nonmarket encounters

Marshall, we have been able to draw economic models showing monopoly to be inefficient (i.e., welfare reducing) and competition to be efficient. But all of these models assume that the amount of "welfare" produced by each relevant dollar is constant. Thus the mere "wealth transfer" that results from monopoly (as opposed to the "deadweight" loss) is welfare neutral. But if the assumption is wrong and consumers as a group do place a higher value on the dollars transferred than the monopolist does, then the "social cost" of the monopoly is greater than the model suggests. If consumers place a lower value on these dollars, it is less.

244. The leading Progressive literature includes WILLIAM CHANDLER BAGLEY & STEPHEN SHELDON COLVIN, HUMAN BEHAVIOR (1919); JOHN DEWEY, HOW WE THINK (1910); WILLIAM MCDOUGALL, AN INTRODUCTION TO SOCIAL PSYCHOLOGY (1909); MAX F. MEYER, THE FUNDAMENTAL LAWS OF HUMAN BEHAVIOR (1911); I.P. PAVLOV, CONDITIONED REFLEXES: AN INVESTIGATION OF THE PHYSIOLOGICAL ACTIVITY OF THE CEREBRAL CORTEX (1927); J. WATSON, BEHAVIORISM, *supra* note 204; JOHN B. WATSON, PSYCHOLOGY FROM THE STANDPOINT OF A BEHAVIORIST (1919); ALBERT PAUL WEISS, A THEORETICAL BASIS OF HUMAN BEHAVIOR (1925); Floyd H. Allport, *Behavior and Experiment in Social Psychology*, 14 J. ABNORMAL PSYCHOLOGY 297 (1919); Ralph Barton Perry, *The Mind Within and the Mind Without*, 6 J. PHIL., PSYCHOLOGY & SCI. METHODS 169 (1909); Edgar A. Singer, Jr., *Mind as an Observable Object*, 8 J. PHIL., PSYCHOLOGY & SCI. METHODS 180 (1911); Robert M. Yerkes, *Behaviorism and Genetic Psychology*, 14 J. PHIL., PSYCHOLOGY & SCI. METHODS 154 (1917). On Watson, see DAVID COHEN, J.B. WATSON: THE FOUNDER OF BEHAVIORISM (1979).

245. *See* text accompanying note 203 *supra*.

246. On behaviorism in sociology, see L.L. BERNARD, THE TRANSITION TO AN OBJECTIVE STANDARD OF SOCIAL CONTROL (1911); L.L. Bernard, *The Objective Viewpoint in Sociology*, 25 AM. J. SOC. 298 (1919); F. Stuart Chapin, *Measurement in Sociology*, 40 AM. J. SOC. 476 (1935); *see also* EDWARD A. PURCELL, THE CRISIS OF DEMOCRATIC THEORY: SCIENTIFIC NATURALISM AND THE PROBLEM OF VALUE 34-38 (1973).

247. OLIVER WENDELL HOLMES, THE COMMON LAW (1881); *see also* note 265 *infra*.

248. *See* Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457 (1897).

between individuals—with transactions that cannot be mimicked in the market, not even conceptually. If positivist law & economics consistently followed its own methodological scruples, it would be unable to give advice about welfare consequences in most situations to which the law applies. But today's law & economics does not practice what it preaches. It in fact engages in incessant interpersonal comparisons of utility, even though it expressly abhors such comparisons as a basis for measuring social welfare.[249]

For example, in *Economic Analysis of Law*, Judge Posner argues that the optimal sanction must be sufficiently large so that the criminal derives less utility from committing the act (when faced by the sanction, suitably increased to offset the uncertainty of detection) than from not committing it.[250]

But how does one determine the amount of utility that the criminal derives from his crime? In the case of theft, Posner lets the fenced value of the stolen article act as a surrogate for the utility to the criminal, e.g., if the criminal can sell the stolen jewel for $500, then the optimal fine would be approximately $501, times the inverse of the probability of detection.[251] However, as soon as the crime involves a transaction where the market cannot easily be mimicked, such as forcible rape or mayhem, then estimating the criminal's utility becomes impossible. Any effort to assess a suitable penalty in an individual case would require a reliable, truthful statement from the criminal that he received more disutility from a particular sanction than he did utility from the crime for which the sanction was being administered. Any effort to formulate a general sentence for all defendants convicted of such a crime would require interpersonal comparisons of utility and would thus be purely normative. The decision that twenty-five years is the optimal sentence for arson is no more scientific by the positivist economist's criterion than the decision that progressive taxation will make society better off.[252]

This problem of interpersonal comparison seems essential to legal rulemaking, and it is not easily solved by hypothesizing revealed market

249. More than sixty years ago, Chicago economist Jacob Viner criticized neoclassical welfare economists for purporting to measure only subjective individual welfare but unconsciously jumping to an objective standard as soon as they were required to evaluate the consequences of nonmarket or group transactions. "[M]uch of what passes for utility theory is really objective price-theory presented in the purloined terminology of subjective analysis . . . ." Viner, *supra* note 42, at 657.

250. R. POSNER, *supra* note 6, at 205-07.

251. *Id.* at 203-04.

252. Judge Posner acknowledges this to a degree. He notes that "one cannot know with anywhere near the same confidence" whether an involuntary shift in wealth is efficient. His response is pure instrumentalism:

> But if we insist that a transaction be truly voluntary before it can be said to be efficient . . . we shall have very few occasions to make judgments of efficiency . . . . An alternative approach, which is in the spirit of Kaldor-Hicks . . . is to try to guess whether, if a voluntary transaction had been feasible, it would have occurred.

Id. at 14.

preferences. Suppose it could be shown that *B* will pay more money to avoid having his arm cut off than *A* would pay to avoid having his nose pinched.[253] This suggests several possibilities: (1) *B*'s pain in having his arm cut off is greater than *A*'s pain in having his nose pinched; (2) *B* has more money than *A* and, since the marginal utility of money declines as one has more, *B* is willing to spend more than *A* for something *B* wants; (3) *B* simply receives less utility from a given amount of money than *A* does, whether or not they have the same amount. None of these three propositions is scientific under the positivist constraint. Proposition (1) is an example of the kind of statement that the ordinalists claimed not to be subject to scientific investigation.[254] Proposition (2) has an empirical element—namely, whether *B* has more money than *A*—but the fact that *B*'s marginal utility for money declines as he has more does not tell us whether *B* dislikes *X* more than *A* dislikes *Y* unless we can compare their marginal utility curves, which we cannot do.[255] Proposition (3) likewise requires interpersonal comparisons of utility.

Wealth-maximization, sometimes chosen by economists as a surrogate for welfare,[256] also fails to distinguish among the three numbered propositions. Wealth-maximization estimates welfare strictly in terms of people's manifested willingness to pay for something: if *A* is willing to pay one dollar for a doughnut and cup of coffee but *B* is willing to pay two dollars, wealth is maximized by giving them to *B*, regardless of who is richer, who is hungrier, or even whether *B* is actually required to pay.

But wealth-maximization has nothing to do with "welfare" in the legal policymaker's sense, unless we are willing to hypothesize that one dollar (or what it will buy) represents the same amount of welfare for everyone: in short, that different individuals have identical marginal utility curves for money. That assumption is a clear violation of any rule against making untestable interpersonal comparisons of utility.[257] Giving something to the highest bidder can be said to increase welfare

253. One could observe that *A* himself would pay more not to have his arm cut off than not to have his nose pinched; that *B* would do the same, etc. From this one could derive a testable hypothesis that persons in general would prefer not losing arms to not having their noses pinched. But even this would not enable us to come up with the optimal penalty, or even to conclude that the penalty for cutting off someone's arm should always be higher than the penalty for pinching someone's nose. Although both *A* and *B* individually experience more disutility from having their arms cut off than from having their noses pinched, *B* may nevertheless experience more disutility from having his nose pinched than *A* experiences from having an arm removed.

254. *See* text accompanying notes 211-221 *supra*.

255. For example, it is quite possible that *A* has more money than *B*, that for each of them the marginal utility of money declines as they have more, but that *B* would nevertheless pay more not to have his arm cut off than *A* would pay not to have his nose pinched.

256. *See* Richard A. Posner, The Economics of Justice 48-115 (1981).

257. One of the truly astonishing things about modern neoclassical economics, particularly of the Chicago School variety, is that it first rejects classical utilitarian welfare economics as unscientific because interpersonal comparisons of utility are impossible, but then turns around and uses a principle called "wealth-maximization" that assumes the utility of dollars can be compared interpersonally.

only if we know that the bidders derive exactly the same amount of utility from the dollars they are bidding.

Is the legal policymaker acting "unscientifically" when she determines that the wrongdoer who cuts off *B*'s arm deserves a greater penalty than the offender who pinches *A*'s nose? Most of those setting criminal penalties would find this not to be a subtle distinction. More importantly, does law give up its claim to being "scientific" when it predicates that cutting off *B*'s arm is more harmful than pinching *A*'s nose?

No, not if we permit objective manifestations of well-being to serve as the basis for verifying our theory that cutting off an arm is more painful than pinching a nose. Examination of defined physical responses of a statistically significant number of *A*s and *B*s will certainly reveal that on average the *B*s are suffering more. In this case, the law is much more like behavioral psychology than economics. The behavioral psychologist can feel another person's pleasure and pain no better than the economist can, but she is not acting "unscientifically" as her own discipline defines that term. The behavioral psychologist uses observable responses as a surrogate for pain in the same way the wealth-maximizing economist uses wealth as a surrogate for welfare. If one child yawns and then dozes while listening to a lecture on the wealth-maximizing effects of the common law and another laughs and coos while attending the circus (and I have done a reasonably good job of accounting for other variables) I can conclude with some confidence that the second received more pleasure from the circus than the first from the lecture. The behavioralist needs a premise similar to this in order to verify her theories on the relative enjoyment a child will experience at different events.

One can debate whether the contribution of the ordinalists constituted "progress" in economic theory. But legal policymakers have always been concerned with welfare objectively considered—and when one considers welfare objectively, questions about interpersonal comparison of utilities become quite unimportant. For example, in considering whether to tax the wealthy to provide education to the poor, the legal policymaker generally does not use opinion polls or studies of market behavior to determine whether the poor would pay more for an education than the wealthy would pay not to be taxed. Rather, she makes judgments about the effect of education on the unemployment rate or the ability of parents to feed their children, or the impact of the tax on the taxpayer's work incentives. While she might not be able to reduce these utility considerations to an exact number, her surrogates seem much closer to the values she considers relevant to the public policy calculus.

In this sense the first great law & economics movement was much closer to the essence of legal policymaking than is the law & economics movement of today. One of the most naïve and counterproductive features of the law & economics movement is its continued insistence that involuntary wealth transfers should be understood as having no scientifically measurable effect on "welfare," by which the economist means allocative efficiency. Within economic parlance, any defense of such transfers is automatically deemed "normative," which is usually just another way of saying that its motivation is political.

C. *Law, Economics, and the External Standard*

1. *The external standard in preordinalist law & economics.*

The ordinalist critique of utilitarian welfare economics was based on the premise that utility, pain, pleasure, preference, or anything else utilitarians might wish to measure must be treated as subjective feelings on the part of those experiencing them. Since one person cannot experience another person's feelings, interpersonal comparisons of utility are not possible.

None of this was a new discovery. Most preordinalist neoclassicists knew that subjective feelings could not be compared across persons. Premarginalist classicism had never faced the problem because its theory of value was generally based on cost rather than marginal utility. Previously, invested cost was an objective factor. For this reason some prominent American economists, such as Harvard's Silas M. Macvane, criticized the subjectivism inherent in utility theory, and clung resolutely to the classical, objective theory of value.[258]

For Americans more sympathetic with neoclassicism, the problem of interpersonal comparisons of utility was known as early as 1892. Yale economist Arthur Twining Hadley gave an extremely harsh review of University of Pennsylvania economist Simon N. Patten's new book, *The Theory of Dynamic Economics*.[259] The entire book was fallacious, Hadley argued, because it committed the error of comparing utilities across individuals. Most of Patten's reasoning was "directly, though not explicitly, based on the assumption that articles which have the same value have the same marginal utility to different consumers—a palpable mistake, which entirely vitiates all proof based upon it."[260] Patten responded with a defense that his analysis contained "no comparison of the pleasures and pains of one man with those of another man."[261] Rather, Patten had merely assumed that as the amount of goods increases or decreases, corresponding increases or decreases in welfare

258. S.M. Macvane, *Marginal Utility and Value*, 7 Q.J. ECON. 255, 269 (1893) (criticizing the Austrian value theory). Thus, for example, Macvane defended the wage-fund doctrine from the emerging rule that wages are determined by the value of the marginal laborer. S.M. Macvane, *Analysis of Cost of Production*, 1 Q.J. ECON. 481, 483 (1887).

259. SIMON N. PATTEN, THE THEORY OF DYNAMIC ECONOMICS (1892).

260. Arthur T. Hadley, *The Theory of Dynamic Economics* (Book Review), 7 POL. SCI. Q. 562, 562 (1892).

261. Simon N. Patten, *Some Explanations Relating to the "Theory of Dynamic Economics,"* 7 Q.J. ECON. 177, 179 (1893).

"are all in the same direction."[262] That is, he had made ordinal rather than cardinal measurements of utilities.

Most neoclassicists addressed the problem of interpersonal comparison by defining "utility" for economic purposes as objectively perceived welfare across averaged groups of people. Although the ordinalists looked to Vilfredo Pareto for a welfare criterion, Pareto himself was a utilitarian. He distinguished subjective feeling, which he termed "ophelimity," from objective measures of productivity or happiness, which he termed "utility." Although ophelimity could not be compared from one person to another, utility could be.[263]

Robbins read the utilitarian economists as if they dealt only with the subjective welfare experienced by individuals and proclaimed this to be out of the reach of economic science.[264] That approach seems peculiarly out of touch with the most important contemporaneous intellectual development in jurisprudence: the external standard.

The scientific revolution in jurisprudence manifested itself in the external standard, which derived assessments of welfare, guilt, or intent from external acts or evidence rather than perceived subjective feeling. The external standard, advocated by Holmes as early as the 1870s,[265] was one of the more obvious manifestations of the movement away from a jurisprudence grounded in morals and natural law to one based on positive declarations of state policy. Whatever status the ordinalist

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262. *Id.*

263. 1 V. PARETO, *supra* note 227, at 3; 2 *id.* at 48-49; VILFREDO PARETO, MANUEL D'ECONOMIE POLITIQUE (1927).

264. Chicago economist Frank Knight had expressed the problem already in 1925, but he drew exactly the opposite conclusion from Robbins. That is, economic science must measure utility objectively:

> Science . . . deals with *observed facts*, and their relations of coexistence and sequence. It must rigorously exclude "metaphysical entities" of every sort. And a feeling, manifestly, is not an "observed fact"; it is an inference from the behavior itself, or at most it is "reported," which is to say that it is inferred from a report, which report itself is but an observed behavior fact. . . . The purpose of knowledge is to predict, and the use of prediction is control. But we can predict only on the basis of some readily observable and identifiable mark or condition. It is useless to know that a human being who feels in a certain way will act in a certain way, unless we have some perceptible indicator of the feeling, which indicator can be only a behavior fact.
>
> Thus, unless it is assumed that feelings have some real existence apart from the observable physical facts pertaining to the organism, they are superfluous in explaining behaviour . . . .

Knight, *supra* note 233, at 375-76.

265. Holmes first argued that subjective standards of culpability were outmoded and should be replaced by an external standard in *The Theory of Torts*, 7 AM. L. REV. 652 (1873) (unsigned article written by Holmes). His book, THE COMMON LAW, is an extended argument that judges, regardless of their rhetoric, rely on external standards of human behavior in making legal policy. O.W. HOLMES, *supra* note 247; *see* MARK DEWOLFE HOWE, JUSTICE OLIVER WENDELL HOLMES: THE PROVING YEARS 1870-1882, at 196 (1963); *see also* Robert W. Gordon, *Holmes' Common Law as Legal and Social Science*, 10 HOFSTRA L. REV. 719, 720 (1982); Hovenkamp, *supra* note 118, at 662-64; William A. Lundquist, *Oliver Wendell Holmes and External Standards of Criminal and Tort Liability: Application of Theory on the Massachusetts Bench*, 28 BUFFALO L. REV. 607 (1979) (student author). For a thoughtful discussion of the external standard in American Pragmatism and its influence on Holmes, see Thomas C. Grey, *Holmes and Legal Pragmatism*, 41 STAN. L. REV. 787 (1989).

revolution may have had in economics, it was quite inconsistent with the behavioralist revolution taking place in the law. The effect of the ordinalist revolution was to make the emerging welfare economics, based strictly on a subjective notion of utility, quite irrelevant to most forms of legal policymaking. As Roy Harrod put it in 1938, ordinalism, carried to its logical conclusion, deprived the economist of his "advisory role" to legal policymakers.[266] The economist must be able to deal in probability and description of reality, objectively considered, but the policy question of what improves welfare is quite different than the price theory question of what does:

> If the incomparability of utility to different individuals is strictly pressed, not only are the prescriptions of the welfare school ruled out, but all prescriptions whatever. The economist as an adviser is completely stultified, and, unless his speculations be regarded as of paramount aesthetic value, he had better be suppressed completely.[267]

The legal policymaker must continually make assessments about the distribution of wealth or entitlements among individuals. The ordinalist rather easily concludes that to question whether "welfare" is improved by involuntary wealth transfers is a normative rather than scientific act. The question is then not part of economics. But the legal policymaker does not have so large a trash bin. She must decide some questions, whether or not the economist considers them to be within the realm of economic science. In this sense, the scope of legal science and of postordinalist economic science differ.

Law usually measures welfare in the same way that psychologists measure pain or pleasure: by objective criteria that are used to generalize across groups of people and are not subject to the criticism that they require interpersonal utility comparisons.[268] The ordinalist critique was thus a stricture on economic methodology but not on legal methodology. In this sense, the first great law & economics movement addressed the problems of legal policymaking more realistically than does the 1970s movement.

In 1918, John Maurice Clark argued that welfare economics should take modern psychology more seriously in addressing questions of value.[269] Economics had always purported to take individual economic wants as it found them, without making value judgments. "[W]e built economics on the idea of rational choosing, only to be told [by the psychologists] that rational choosing is but a small and very imperfectly developed part of our mental life."[270] Furthermore, Clark noted that

266. R.F. Harrod, *Scope and Method of Economics*, 48 ECON. J. 383 (1938).

267. *Id.* at 397.

268. *See, e.g.*, E. SELIGMAN, THE INCOME TAX, *supra* note 61, at 32 (in policymaking, "the government can deal only with classes").

269. J.M. Clark, *Economics and Modern Psychology*, 26 J. POL. ECON. 1 (1918).

270. *Id.* at 7. Compare this with Wesley C. Mitchell's *The Rationality of Economic Activity*, 18 J. POL. ECON. 197, 197 (1910), taking issue already in 1910 with the economist's supposition of the rationality of human action and arguing that psychology and sociology suggested

psychology showed that human preference was itself a social rather than individual activity. Neoclassical economics posited that one person's desires were unrelated to those of others. If there was a relationship between one person's utility and another's, it was not considered relevant to economic science.[271] Economists had always considered the self a "sovereign will." Thus, according to Clark, human wants are molded by the environment that all individuals share in common, and over a large range, humans respond in similar ways to similar external stimuli.[272] As a result,

> [I]n proportion as scientific research progresses, minimum standards of welfare will become more and more matters of social knowledge and less and less matters of individual taste—but only minimum standards relating to those necessities which are generally accepted as such.[273]
>
> . . . .
>
> Of the many cruel shocks which the study of psychology has in store for the self-satisfaction of the naïve and innocent beginner, perhaps the most disconcerting comes when he is forced to conceive of his sovereign personality as reacting to the stimuli furnished by the outside universe rather than as generating its own stimuli and acting independently upon the universe . . . .[274]

In fact, Clark observed in 1915, despite the rhetoric about subjective value as the data of economics, the use of external standards in economics was widespread and essential to the public policy function of the discipline. "Enough instances could be easily cited to show the all-pervading economic influence of standards of value contrary to those of the free market."[275] In reality,

> economists do use these standards constantly in their practical thinking on matters of public policy, but somehow the theory of value and distribution seems insulated. If we can develop a concept of social value and valuation independent of market valuations and capable of scientific

the contrary. *See also* Hamilton, *The Institutional Approach to Economic Theory*, *supra* note 177, at 316 (arguing for a "theory of motives . . . in harmony with the conclusions of modern social psychology").

271. See also economist Wesley C. Mitchell, *Human Behavior and Economics: A Survey of the Literature*, 29 Q.J. ECON. 1, 2 (1914), criticizing the view that economic theory rests "upon the simple facts of preference or choice, and the psychological explanation of these preferences or choices is . . . a matter of indifference to our science."

272. *Id.* at 7-8.

273. Clark, *supra* note 269, at 10.

274. *Id.* at 11. Many argued that economics should take a behaviorist approach to the measurement of economic preference or welfare. *E.g.*, *id.* at 12 (to the extent that people are conditioned by their environment, they are alike rather than different, and the scientist can generalize); *see also* Lawrence K. Frank, *The Emancipation of Economics*, 14 AM. ECON. REV. 17 (1924); A.J. Snow, *Psychology in Economic Theory*, 32 J. POL. ECON. 487 (1924). For a critique, see Knight, *supra* note 234; *see also* RALPH WILLIAM SOUTER, PROLEGOMENA TO RELATIVITY ECONOMICS: AN ELEMENTARY STUDY IN THE MECHANICS AND ORGANICS OF AN EXPANDING ECONOMIC UNIVERSE (1933); Frank H. Knight, *The Nature of Economic Science in Some Recent Discussion*, 24 AM. ECON. REV. 225 (1934). Knight insisted that economics retain its distinctiveness by studying individual rather than conditioned preferences, regardless of their justification.

275. J.M. Clark, *The Concept of Value—A Rejoinder*, 29 Q.J. ECON. 709, 712 (1915).

> application to concrete cases, we shall have an intellectual instrument that will pierce the insulation and establish a working connection with the ideas that are making things happen.[276]

Clark cited the common law doctrine of *damnum absque injuria*—that there could be a wrong without a remedy—as an instance where society recognized certain values that the market did not.[277]

Many Progressive social scientists reflected Clark's attack on neoclassicism's uncritical individualism. As early as 1901, E.R.A. Seligman argued that "[v]alue in society depends upon the fact not only that each individual measures the relative urgency of his own different wants, but that he compares them, consciously or unconsciously, with those of his neighbors."[278] As a result, any economic theory of value must concede that economics is a science of social rather than individual behavior.[279] Michigan sociologist Charles Horton Cooley faulted neoclassical economics for taking individual subjective desire as its basic datum, for such desires are socially conditioned by existing institutions. Therefore, Cooley argued, the economist unconsciously accepted existing institutions as given and lost his power to criticize them.[280] In 1931, Morris Copeland argued that economics is "first of all a social science. It is not primarily concerned with individual behavior."[281] For example, consumer choices "are effects as well as causes of business policy."[282] As a result, when the neoclassicist bases his theory of value on individual consumer choice, he has "confused description and appraisal."[283] The very act of assuming that individual preference determines value was normative.

2. *The external standard and common law adjudication.*

Positivist economic methodology is concededly "behaviorist" in the sense that it uses particular observable datum, namely people's vote with their dollars, as a surrogate for welfare. But the principal domain of law & economics is "nonmarket" behavior. Tort law, family law, environmental law, criminal law, and the law of civil rights—all of these are concerned predominantly with questions about the allocation of resources respecting nonmarket relationships between persons.

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276. *Id.* at 713.

277. *Id.* at 711-12.

278. Edward R.A. Seligman, *Social Elements in the Theory of Value,* 15 Q.J. ECON. 321, 323 (1901).

279. *Id.* at 323-24. Stating the other side is Sidney Sherwood, *The Philosophical Basis of Economics, A Word to the Sociologists,* 10 ANNALS 206 (1897), arguing that the sociologists' theory of value, as presently developed, was too imprecise to be used by economists.

280. Charles H. Cooley, *The Institutional Character of Pecuniary Valuation,* 18 AM. J. SOC. 543, 546-50 (1913).

281. Morris A. Copeland, *Economic Theory and the Natural Science Point of View,* 21 AM. ECON. REV. 67, 68 (1931); *see also* Edie, *supra* note 177, at 420-21 (important to measure value socially rather than individually).

282. Copeland, *supra* note 281, at 70.

283. *Id.*

Although contract law is certainly a market facilitator, many of the legal rules of contract are themselves outside the market, in the sense that they cannot be bought and sold because they are not subject to waiver. In these cases we do not observe persons voting with their dollars by purchasing or refusing to purchase. In such situations, what do we mean when we say that a particular legal rule increases or decreases welfare?

Judge Posner argues that the common law should be viewed as "efforts, whether or not conscious, to bring about either Pareto or Kaldor-Hicks efficient outcomes" with respect to the transactions at issue.[284] Further, an important premise is that

> [p]eople act as rational maximizers of their satisfactions in making such nonmarket decisions as whether to marry or divorce, commit or refrain from committing crimes, make an arrest, litigate or settle a lawsuit, drive a car carefully or carelessly, pollute (a nonmarket activity because pollution is not traded in the market), refuse to associate with people of a different race, fix a mandatory retirement age for employees.[285]

Judge Posner then argues that the common law has generally worked to mimic the market—applying to nonmarket encounters rules equivalent to those that a market transaction would have generated. Since the latter can be shown to be efficient under traditional Pareto criteria, the overall tendency of the common law has been toward the maximization of social welfare.

As an example of the common law's search for efficiency, Posner gives the doctrine of "ancient lights"—the prescriptive easement to light that overdeveloped England recognized but underdeveloped America did not.[286] The American rejection of ancient lights involved a transfer of wealth to the class of people who are developing or will develop, and away from agrarian interests or people who already have developed. In the Kaldor-Hicks sense, the change is efficient if the gains experienced by the developers are greater than the losses experienced by the nondevelopers. As Posner explains,

> Suppose that at first people live in very close proximity to each other. Natural light will be a scarce commodity in these circumstances, so its value in exchange may well exceed the cost of enforcing a property right in it. Later, people spread out, so that the value of natural light (in the economic sense of value—exchange value rather than use value) falls; then the net social value of the property right (i.e., the value of the right minus the cost of enforcing it) may be negative.[287]

284. Richard A. Posner, *The Law and Economics Movement*, 77 AM. ECON. REV., May 1987, at 1, 5 (papers & proceedings).

285. *Id.*

286. *Id.* at 6; *see* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 413 (2d ed. 1985).

287. Posner, *supra* note 284, at 6.

This sounds reasonable enough as an after the fact explanation. Of course, if the common law went the other way, then the opposite story could just as easily be told. But, in any event, how would a judge confronted with such a case apply a wealth surrogate when there are no actual market transactions to observe? Somehow, we would have to measure the gain to those favoring the rule and the loss to those opposed. If those who gained were willing to pay more for abolition of ancient lights than those who lost were willing to pay to retain ancient lights, then abolition of ancient lights increases welfare, assuming the constant marginal utility of dollars.

Importantly, however, we would have substituted an objective judgment, namely market value, for a subjective one. When we make the above judgment, we are not observing actual voluntary market transactions. Rather, we are looking at external manifestations of welfare and attempting to quantify how much the developers are "better off" under the American rule.

As the legal problem moves further away from the market, the subjective purchase price becomes truly unknowable and objective welfare criteria must take over. For example, Judge Posner defends the public figure rule in libel cases, which makes it easier for private figures than public ones to win, because (1) the "external benefits of information about public figures are greater than those of information about private figures, and therefore, the argument for allowing some of the costs to be externalized is stronger"; and (2) "a public figure, being by definition newsworthy, has some substitute for legal action: He can tell his side of the story, which the news media will pick up."[288]

Once again, there are no market transactions to observe. Judge Posner is making some common sense observations that sound plausible enough,[289] but he is using the psychologist's rather than the economist's standard of welfare. To the observer, the public seems to be better off if they can have ready access to information about public figures. Public figures seem to be less injured by acts of libel because they have access to the media. Once law & economics ventures into the arena of nonmarket transactions—where most of law & economics occurs—then there are no longer transactions to observe and one begins looking at external indicia of welfare. That is no different from the interpersonal comparison of utilities that Robbins attacked.[290]

A second problem with using market value as a surrogate for wel-

288. *Id.* at 8.

289. On the value of plausibility of economic assumptions to the positivist, see M. FRIEDMAN, *supra* note 222; *see also* BRUCE J. CALDWELL, BEYOND POSITIVISM: ECONOMIC METHODOLOGY IN THE TWENTIETH CENTURY 174, 177 (1982).

290. Posner himself recognizes a testability problem with respect to nonmarket transactions. "[When] one is examining the effects of behavior on law rather than of law on behavior, the dependent variable tends not to be quantitative: it is not a price or output figure but a pattern of rules." Posner, *supra* note 284, at 6. This is a different problem than the one I am discussing.

fare is that the preexisting rules of the market and distribution of resources will affect what someone will pay for any given thing. Already in 1919, John Maurice Clark had recognized that the question of what can be purchased and sold on the market is principally legal, historical, and institutional. The economist who is unable to evaluate welfare without a market, has nothing to say about most social relationships.[291]

> [I]n some places an owner of real estate can secure an "easement of light and air" protecting him against what would otherwise be an uncompensated damage to his property when someone puts up a high building on the adjoining lot. This damage to property is an economic fact where the owner is so protected, but where the law does not make such protection possible, shall we be told that this same damage is not an economic fact at all, but purely an ethical one? Such an attitude would stultify any attempt to make economics fully and actively relevant to social changes.[292]

The price economist can measure "loss" only in circumstances where the law has created an exchangeable value with respect to the interest. If the interest cannot be exchanged, then the economist cannot even proclaim that the property owner has been injured, let alone determine the extent of injury.

How did the common law reach the result it did in the ancient lights cases? Manifestly, not by engaging in the statistical comparison of large numbers of observed transactions in America and England, and concluding that, on balance, American developers were generally willing to buy the right to build in America while English developers were not.

First of all, the common law judge was almost never looking at a case in which a voluntary transaction had occurred, but rather at a case in which it had not. Most likely, he was looking at a case in which a developer had built or was about to build, and now a neighbor was suing under the doctrine of ancient lights. As a result, the common law judge did not rely on market behavior or even on revealed preference. At most, he made some kind of calculation about the kind of injury, externally measured, that would accrue to a group of people in the plaintiff's position if the doctrine of ancient lights were overturned, and weighed, that against the kind of "injury," externally measured, that would accrue to potential developers if the doctrine were maintained. In short, the common law became "efficient"—if efficient it is—because judges indulged in something resembling interpersonal comparisons of utilities. They performed a utility calculus based on external objective manifestations and adopted the rule they felt would

291. On this point, see Tibor Scitovsky, *The State of Welfare Economics*, 41 AM. ECON. REV. 303, 314-15 (1951).

292. J.M. Clark, *Economic Theory in an Era of Social Readjustment*, 9 AM. ECON. REV., May 1919, at 280, 287 (papers & proceedings). Clark apparently believed that there were some jurisdictions where such easements could not be created by voluntary transaction.

maximize aggregate utility. Welfare was measured externally and socially.

The meaning of "welfare" with respect to legislation or the public policy of the state is even more clearly objective. Many Progressives reacted to the perceived laissez-faire of the Gilded Age by calling for a "social" as opposed to an individual point of view in legal policymaking. Some people, such as jurisprudent Roscoe Pound,[293] were almost obsessed with the "social" viewpoint in law. Similar language appears in the work of prominent Progressive economists such as Richard T. Ely,[294] and even more traditional ones such as John H. Gray and John Maurice Clark. In 1915, Gray argued that the field of law & economics should be concerned with group needs rather than individual preference.[295] By 1919, John Maurice Clark believed, economic theory had clearly become divided into two areas. "On the one side stands a body of thought marked off as a deductive system, dealing with the mechanism of free exchange . . . ." This type of theory "takes human choices as it finds them in the market, without asking if they are rational, impulsive, or what not."[296] The second branch, which Clark branded "social economics," included Mill's discussions of property and communism, the economics of public finance, J.B. Clark's *Philosophy of Wealth*,[297] and the work of Veblen and Hobson.[298]

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293. *E.g.*, ROSCOE POUND, AN INTRODUCTION TO THE PHILOSOPHY OF LAW (1922); Roscoe Pound, *Justice According to Law*, 13 COLUM. L. REV. 696, 708 (1913); Pound, *Liberty of Contract*, *supra* note 107, at 487; Roscoe Pound, *The Need of a Sociological Jurisprudence*, 31 REP. A.B.A. 911, 920 (1907); Roscoe Pound, *The Scope and Method of Sociological Jurisprudence*, 25 HARV. L. REV. 489, 489-90 (1912); Roscoe Pound, *Social Justice and Legal Justice*, PROC. 30TH ANN. MEETING MO. B.A. 110, 120 (1913).

294. R. ELY, *supra* note 83; *see also* E. Benjamin Andrews, *Individualism as a Sociological Principle*, 2 YALE REV. 13 (1893) (economist arguing for a social rather than individual viewpoint in economics); H.J. Davenport, *Doctrinal Tendencies—Fetter, Flux, Seager, Carver*, 14 YALE REV. 300 (1905) (economist comparing theoretical economic viewpoints); D.I. Green, *Value and Its Measurement*, 7 YALE REV. 383 (1899) (same); Arthur T. Hadley, *Recent Tendencies in Economic Literature*, 3 YALE REV. 251 (1894). Hadley identified British neoclassicism with the individual theory of value and the German Historical School with the social theory of value. Hadley, a critic of the German Historical School, conceded that its value had been "to show that free-will has perhaps much less to do with economic demand than some people suppose, and custom much more; and to insist on the study of the motives which sway the action of masses, as distinct from those which affect that of individuals separately." *Id.* at 257. On the other hand, the German Historical School laid "too much stress on law and customs." *Id.*; *see also* Raymond J. Heilman, *The Correlation Between the Sciences of Law and Economics*, 20 CALIF. L. REV. 379, 394-95 (1932) (arguing that the principal difference between legal theory and economic theory is that the former measured value across large groups while neoclassical economics did so individually). A law & economics movement would require a more sociological economics.

295. John H. Gray, *Economics and the Law*, 5 AM. ECON. REV., May 1915, at 3 (papers & proceedings).

296. Clark, *supra* note 292, at 280-81.

297. JOHN B. CLARK, THE PHILOSOPHY OF WEALTH: ECONOMIC PRINCIPLES NEWLY FORMULATED (1885).

298. Referring to JOHN A. HOBSON, THE EVOLUTION OF MODERN CAPITALISM: A STUDY OF MACHINE PRODUCTION (1894); *see also* JOHN A. HOBSON, ECONOMICS AND ETHICS: A STUDY IN SOCIAL VALUES (1929) (summarizing Hobson's theory of value); sources cited in notes 139-146 *supra*.

Clark noted that economists in the classical tradition had always recognized the legitimacy of "social economics." They had treated it as less scientific than traditional economics, because social economics could not use observed individual choice as its only measure of welfare. "Social economics lacks quantitative definiteness and coherence, largely because there is no yardstick of social [as opposed to individual] value."[299] By the same token, however, traditional price economics "has only a limited bearing on current issues, just because it does accept the yardstick of the market . . . ."[300]

Clark noted that the work of every major economist since Adam Smith had been historically contextual. In fact, each author addressed the pressing problems of his day even though their work purported to be concerned mainly with theory. The problem of emerging price theory was its inability to act as a critique of current social problems. In his quest for exactitude of measurement, the positivist and ordinalist economist was losing his relevance to the policymaker. Traditional price theory measured individual preferences within the context of given institutions, but was a poor mechanism for criticizing the institutions themselves.

IV. Conclusion

Four things account for the increasing interest in law & economics at the turn of the century: (1) the widespread application of evolutionary models to the development of both law and economic theory; (2) the influence of the German Historical School, which encouraged economists to spend more time studying social institutions, including law; (3) the rise of utilitarian welfare economics, with its enhanced concern about the relationship between distribution and efficiency; and (4) the development of the social sciences, which were perceived to include both law and economics, and the widespread belief that the social sciences must somehow be "unified."

One might dispute the existence of a first great law & economics movement by denying that what its contributors did was really "economics" at all. The modern law & economics movement is based on a much narrower conception of economic science. Some of its protagonists characterize writing that falls outside that conception as not "economic." But only the most historically myopic would accept such a view. Determining the scope of economics in 1900, just as determining the scope of economics in 1980, is a question of expediency and political relevance.

Why did the ordinalist critics of Progressive law & economics make

299. Clark, *supra* note 292, at 281. Clark suggested some possibilities for a social measure of value, for example, that the cost of health care could be measured by the medical profession, "and it is a fair assumption that most people want health." *Id.* at 288.

300. *Id.* at 281.

the value judgments that they did? Principally, it seems, because of a preference for markets over state command as a mechanism for allocating resources. Even under the strictest ordinalist criteria for measuring welfare, markets were welfare enhancing: Someone makes a voluntary exchange only if the exchange makes him better off. Thus, ordinalist economics recovered the strong preference for the market reflected in classical political economy but which had gradually eroded during the late nineteenth century under the marginal utility theory.[301]

Use of the positivist economist's rather than the psychologist's behavioral criterion of welfare has led to quite astonishing real world consequences. One who is skeptical about the scientist's claims to ideological neutrality might suspect that modern neoclassical economics developed with a political agenda. The real reason that neoclassical economics gave up marginal utility as the basis for welfare economics was not because utilitarianism was less "scientific" than the alternatives. Before one could know whether it was scientific, he had to settle on a definition of science. That decision was driven by the fact that marginal utility economics was traveling down a politically unacceptable path, leading economics directly to socialism.

In 1894, J.S. Nicholson, newly elected President of the British Association for the Advancement of Science, warned economists in his presidential address that the emerging marginal utility school was socialistic and was undermining the individualism that had characterized economic classicism.[302] Prominent neoclassicists such as Alfred Marshall and Arthur C. Pigou gradually moved to the left as they grew older, finding an ever increasing role for the state in the redistribution of wealth, which they believed could be justified on scientifically discovered efficiency, or welfare, grounds.[303] America's Progressive econo-

301. In this regard, Frank Knight's comments are telling:

> The development of modern economic theory has undoubtedly been due in the main to the practical drive of concern for social policy as expressed in political (legal and administrative) action. It became a pure science, to the extent that it became such, by way of an interesting development from directly hortatory or propagandist political discussion. Smith's *Wealth of Nations*, from which modern economic theory may be dated, has with much justification been called a political pamphlet. A relatively small fraction of the work requires interpretation in terms of an interest in pure-science, and its main significance is that of propaganda or preaching of policy. Yet it is also the first important general work in scientific economic theory. It becomes scientific without ceasing to be chiefly concerned with advocating a policy. The preaching of a policy naturally takes on the character of a science, when the policy preached is negative, when it is the policy of allowing events to take their natural course. For then the content of the discussion consists chiefly of description of analysis of a "natural" course of events, in the absence of conscious human interference, and this is obviously the character of a science. . . .
>
> There is a "burden of proof" against any proposal of a sweeping change away from free labour, private property, and a free market.

FRANK HYNEMAN KNIGHT, *Economic Theory and Nationalism*, in THE ETHICS OF COMPETITION AND OTHER ESSAYS 277, 285-86 (1935).

302. REPORT OF THE SIXTY-THIRD MEETING, BRITISH ASSOCIATION FOR ADVANCEMENT OF SCIENCE 846-50 (1894).

303. On Alfred Marshall's ambivalent attitude toward socialism, see G.F. Shove, *The*

mists did much the same.[304]

The first great law & economics movement was both more and less than the second law & economics movement. The first movement occurred during a time of revolution in both economic and social theory. The people who engaged in law & economics were also engaged in identifying fundamental assumptions, such as the principle of self-interest, and in determining basic economic concepts, such as the theory of value, the effect of involuntary redistribution, and the scope and meaning of marginalism. For these reasons their work was much more "fundamental" than most of law & economics today. But for these same reasons both the volume of literature and the apparent "progress" of law & economics are much greater now. The second great law & economics movement has developed almost entirely from a consensus neoclassical model in which there is little room to debate fundamental propositions. The model need only be applied. The person engaged in law & economics today is engaged in "normal" science, in Thomas Kuhn's words,[305] while the person engaged in law & economics at the turn of the century was part of a scientific revolution. Progress is what we make of it. The first great law & economics movement reflected as much of it as did the second.

Place of Marshall's Principles *in the Development of Economic Theory*, 52 ECON. J. 294, 316-17 (1942); *see also* Cooter & Rappoport, *supra* note 212, at 519-20.

304. *See* text accompanying notes 58, 88, 163-165 *supra*.

305. *See* T. KUHN, *supra* note 18, at 23-42.